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Special Issue on Islamic Economics and Finance

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Reflecting on the Trajectory of Islamic Finance: From Mit Ghamr to the Globalisation of Islamic Finance

Mehmet Asutay,
Ahmet Faruk Aysan and
Cenk C. Karahan

Every civilisation has, historically, developed their own political, economic, and social order through which the formation of their society has been defined. The Muslims, from the 7th century onwards, aimed to create a system of an Islamic order by developing their own particular social formations according to the norms, principles, and values of Islamic ontology. Therefore, when history is referenced in the search for authenticity, the 'golden years' (*asr al-saadath* or 'the times of felicity') are seen as the necessary framework with which to organise Muslim societies, including their economic and financial systems.

Although the collapse of Muslim socio-political entities by the 20th century created a period of inevitable stagnation in this search for authenticity, the end of colonialism and the emergence of independent Muslim 'nations' provided a new opportunity to establish an identity for these societies. To this end, even though some societies have immediately opted for Islam as their ordering principle, others have sought salvation in non-native systems, namely, secularism in the form of nationalism, socialism, and capitalism. Global political and economic developments, however, resulted in another period of Islamic re-emergence since the 1970s all over the world. Coupled with this new search for authenticity, the rise of the petrodollar in the Middle East provided the necessary incentive to build upon the intellectual foundation of Islamic economics and finance that had been established in the late 1940s. Thus, the 1970s marked an increased intellectual effort to develop Islamic economics and banking along modern lines. The efforts of the founding fathers, such as M. Nejatullah Siddiqi, M. Umer Chapra, S. N. H. Naqvi, Anas Zarka, and Khurshid Ahmad, were heavily engaged in developing a human-centred economic system of Islam as a response to the observed underdevelopment in the Muslim world. As an extension of transforming these efforts into a practical reality, a number of Gulf businessmen and *Shari'ah* scholars aimed at institutionalising such intellectual acumen from early 1970s onwards. Thus, the establishment of the Islamic Development Bank (IDB) in 1974 followed by the formation of the first Islamic commercial bank in 1975 in Dubai. The creation of the IDB constitutes the first Muslim joint effort to find an institutional solution to the economic development problems in the Muslim world after the collapse of Muslim unity; it should therefore be considered as an important landmark in the development of Islamic economics and finance. Conversely, the establishment of the Dubai Islamic Bank as the first commercial bank in 1975 should be perceived as indicative of the rise of commercial corporate culture in the modern sense and the emergence of 'modern businessmen' integrated with the global financial world.

It should be noted that there were other institutionalisation attempts in terms of financing in the Muslim world prior to the first Islamic bank in 1975. In Pakistan during the 1950s, a number of localised attempts at Islamic financing, in the form of *musharakah* projects, could be considered as the precursor to modern Islamic finance. The first institutionalisation of an Islamic social bank and credit provisory institution, namely, Mit Ghamr Bank, came into existence in Egypt in 1963 under the efforts of the late Ahmad Al-Najjar. This first institutionalisation was claimed to be an 'optimal solution' for the economic and social development needs of the Muslim society. Therefore, it is distinguished from Islamic commercial banking, which became the banking model in 1975, as the second institutionalisation phase of Islamic finance.

With regard to *Shari'ah*-compliant investments, they did not necessitate 'institutionalised forms,' as the traditional Islamic financial modes have always remained operational on the periphery of the Muslim world one way or another. Despite the imposed nature of secular economic systems, Islamic modes such as *mudarabah* remained as important financing tools in practice, especially in agriculture in many parts of the Muslim world even in the 20th century. Major institutional development in terms of investment came, however, with the formation of the Tabung Haji in Malaysia, which aimed to invest the savings of Malaysian *bumiputeras* in a *Shari'ah*-compliant way, in that it invested the small savings of Malaysians to pay for their *hajj* trip. Thus, socially responsible investment according to the Islamic moral economy was institutionalised in 1967.

The second stage of the institutionalisation process from 1975 onwards can be traced back to the commercial Islamic banks, which provided the model that shaped the nature and operations of global Islamic finance. The initial strategy in place until the 1990s was overly protective to help this 'infant industry' develop. In order to protect the sector from any potential harms of competition, the 'one country one bank' strategy was embraced to support the early expansion of Islamic finance sector. As a result of the globalisation, internationalisation, and the increased capital accumulation in the GCC region, the Islamic banking and financial institutions have grown beyond their humble beginnings through the 1990s. During this 'globalised' institutional stage, or, in other words, the third institutional formation period, Islamic banks and financial institutions have advanced by leaps and bounds into the mainstream financial industry by attracting the attentions of regulators and private banks all over the world. For example, London was already home to a number of Islamic financial operations in the 1980s, but as early as 1994, the line of communication with the Bank of England was open to discuss the institutionalisation of Islamic banking in the UK, which led to the development of London as one of the centres of Islamic finance activity.

Economic and financial reforms in many Muslim countries during the 1980s and 1990s paved the way for trade and financial liberalisation, as well as financial diversification. Such liberalisation efforts created an opportunity for the expansion of the Islamic finance industry. Beyond the GCC region, emerging Muslim economies such as Indonesia, Malaysia, and Turkey, began to institutionalise Islamic banking in their respective countries from the mid-1980s onwards, while Iran and Sudan opted for full-Islamisation of their financial system. Although the political culture in Indonesia and Turkey has not facilitated the expansion of Islamic banking and finance until recently, Islamic identity-oriented policies in Malaysia resulted in unprecedented incentives for the development of Islamic finance and banking. Malaysian government instituted a strategic financial policy that is very conducive to expansion of Islamic finance. The environment in Malaysia served the Islamic financial sector tremendously by allowing the creation of institutions to build the necessary infrastructure, as well as educational and training initiatives. It should be noted that this has contributed to the development of the industry globally.

The current Islamic finance sector is believed to extend to over ninety countries in various forms (banks and financial institutions, fund management, project financing and so on) with an asset base of over USD$2 trillion by the mid-2012 (The Banker, 2012). Several non-Muslim countries, including the UK, France, and Luxembourg, have facilitated a regulatory and institutional environment conducive to Islamic finance; with many others following in their footsteps to develop such an environment. The motivation behind these moves is mainly to reap the benefits of the increased capital accumulation in the GCC region and, to lesser degree, to extend financial inclusion to their own Muslim population by providing *Shari'ah*-compliant financial services.

Reflecting on the aforementioned developments, Table 1 depicts the state and trends in Islamic banking in fifteen countries for 2009-2012, thereby indicating the success of the sector in terms of asset accumulation.

Table 1: Top 25 Countries by *Shari'ah*-Compliant Assets

2009			2010			2011			2012		
Rank	Country	*Shari'ah*-Compliant Assets $m	Rank	Country	*Shari'ah*-Compliant Assets $m	Rank	Country	*Shari'ah*-Compliant Assets $m	Rank	Country	*Shari'ah*-Compliant Assets $m
1	Iran	293,165.80	1	Iran	314,897.40	1	Iran	387,952.57	1	Iran	465,574.92
2	Saudi Arabia	127,896.10	2	Saudi Arabia	138,238.50	2	Saudi Arabia	150,945.43	2	Malaysia	221,025.52
3	Malaysia	86,288.20	3	Malaysia	102,639.40	3	Malaysia	133,406.38	3	Saudi Arabia	185,223.00
4	UAE	84,036.50	4	UAE	85,622.60	4	UAE	94,126.66	4	UAE	89,309.38
5	Kuwait	67,630.20	5	Kuwait	69,088.80	5	Kuwait	79,647.85	5	Kuwait	78,587.25
6	Bahrain	46,159.40	6	Bahrain	44,858.30	6	Bahrain	78,857.47	6	Bahrain	62,171.53
7	Qatar	27,515.40	7	Qatar	34,676.00	7	Qatar	52,322.38	7	Qatar	45,301.30
8	UK	19,410.50	8	Turkey	22,561.30	8	Turkey	28,015.20	8	Turkey	29,292.86
9	Turkey	17,827.50	9	UK	18,949.00	9	UK	19,041.79	9	UK	18,605.43
10	Bangladesh	7453.3	10	Bangladesh	9,365.50	10	Sudan	12,139.45	10	Indonesia	15,963.97
11	Sudan	7151.1	11	Sudan	9,259.80	11	Bangladesh	11,677.10	11	Bangladesh	12,572.97
12	Egypt	6299.7	12	Egypt	7,227.70	12	Indonesia	10,531.61	12	Sudan	9,825.23
13	Pakistan	5126.1	13	Indonesia	7,222.20	13	Syria	8,690.20	13	Egypt	8,296.32
14	Jordan	4621.6	14	Pakistan	6,203.10	14	Egypt	7,888.22	14	Pakistan	7,328.34
15	Syria	3838.8	15	Syria	5,527.70	15	Switzerland	6,582.48	15	Switzerland	6,551.37

Source: The Banker (various issues).

In substantiating the argument, Table 2 shows the regional dynamics in Islamic banking and finance. As it is apparent in growth trends, Africa and Asia have become the new 'tipping points' of what is now a truly global sector. As the trends in both tables demonstrate, despite the deceleration precipitated by the global financial crisis, Islamic banks and financial institutions have performed well, and a couple of localised defaults notwithstanding, they have not faced any major financial defaults and failures.

Table 2: IBF-Regional and Global Growth Totals ($ million)

	2006	2007	% Change	2008	% Change	2009	% Change	2010	% Change	2011	% Change
GCC	127,826.60	178,129.60	39.4	262,665.40	47.5	353,237.50	34.5	372,484.20	5.5	434,893.10	16.75
Non-GCC MENA	136,157.60	176,822.20	29.9	248,264	40.4	315,090.50	26.9	337,948.20	7.3	416,382.20	23.21
MENA Total	263,984,2	354,951.70	34.5	510,929.40	43.9	668,328.50	30.8	710,434.00	6.3	851,275.30	19.82
Sub-Saharan Africa	3039.3	4708	54.9	6662.1	41.5	8369.7	25.6	10,765.10	28.6	13,711.10	27.37
Asia	98, 709.6	119,346.50	20.9	86,360.30	-27.6	106,797.30	23.7	130,904.10	22.6	166,652.80	27.31
Australia/Europe/ America	20,300.20	21,475.70	5.8	35,105.20	63.5	38,654.80	10.1	42,779.50	10.7	53,939.10	26.09
Global Total	386,033.30	500,481.90	29.7	639,076.90	27.7	822,135.10	28.6	894,882.70	8.9	1,086,462.90	21.41
% of MENA total to Global Total	68.4	70.9		79.9		81.3		79.39		78.35	

Source: The Banker (various issues)

The success of Islamic banks and financial institutions in increasing their operations and asset bases, even during the financial crisis, is an indication of their resilience and vindicates their stability. This success may also be attributed to the business cycles of the countries home to the majority of Islamic banks and financial institutions, as GCC countries, Malaysia and most other Muslim countries have not been deeply affected by the financial crisis. Therefore, it is difficult to isolate the inherent salient features of Islamic finance that contribute to its resilience and stability from the macroeconomic state of the home countries. The recent experience of the sector should be studied further to clarify the distinction.

In critically reflecting on the progress made over the recent years, it has been observed and highlighted that Islamic finance has been converging towards conventional banking and finance in its instruments, operations, and priorities. This move has led to a debate on the aspirations and realities of Islamic finance. The idealistic aspirations of Islamic finance are defined by the Islamic moral economy. However, the reality of Islamic finance is driven by the market conditions and requirements. In fact, commercial Islamic banking in its current form is not necessarily perceived as the best answer to the over-emphasised social and developmentalist goal of the Islamic moral economy. On the other hand, the contribution of commercial Islamic banks and financial institutions in terms of accumulating funds and leading economic growth is evidenced by many empirical studies and through actual experience. Thus, the on-going debate between 'development' and 'growth' has again risen to the top of the agenda for Islamic finance, as the founding fathers aimed for a developmentalist objective, rather than a source of financialization in their conception of Islamic finance.

Considering that the Arab countries as well as the emerging economies of Asia and Africa have turned to Islamic finance in recent years in order to finance economic development and answer employment needs of their constituents (as such demands have led to revolutions as in the case of Arab Spring), it becomes apparent that Islamic finance should also address developmentalist objectives through its operations. Failure to do so will result in the zealot population in the Muslim world, buoyed up on the hype of the expectations for Islamic finance, facing yet another disappointment from the expectation they build for a financial system labelled Islamic. Thus, in this new phase of institutional structuring, developmentalist-oriented Islamic financial institutions, in the form of Islamic social banks, Islamic microfinance, *zakah* funds, and *waqf*s should be built as complimentary institutions alongside the commercial Islamic banks and financial institutions. These non-banking Islamic financial institutions should aim to have a developmentalist impact beyond the economic growth objectives of commercial Islamic banking. Considering that civil society oriented Islamic finance, in the form of Islamic microfinance in Indonesia has immensely contributed to economic development, individual empowerment and capacity building throughout the country, perhaps developmentalist countries should consider non-banking Islamic financial institutions to reach the economic and social objectives. It is also important to note that *sukuk* type of financial products can further contribute to development objectives through infrastructure financing. In addition to the need for institutionalisation, new and authentic financial instruments with a high developmentalist impact should therefore be engineered to contribute to the new micro-trajectories.

Ultimately, the Islamic banking and finance sector has experienced substantial and unprecedented growth in recent years. Although its overall asset size (US$2 trillion in 2012) remains rather small when compared to that of the global financial system, the progress of Islamic finance can better be put in context through increased efficiency and profitability, as is evidenced by many empirical studies. Besides, comparing the current asset size of Islamic banking and finance with the size of assets in 1985 at US$10 billion draws a stark picture of its growth and further potential. . Although the recent success and resilience of Islamic banking and finance cannot be denied, it is important that this ethical financial proposition should remain true to its aspirational worldview in order to be considered a success in terms of making a difference rather than mimicking the conventional banking experience. As with regard to the current practice, the concerns and claims over the practice of Islamic banks and financial institutions deviating from the aspirational values are a valid argument.

This special issue of Afro Eurasian Studies Journal aims to highlight some of the topics discussed so far: a number of empirical papers in the following pages provide evidence of the progress and evaluate performance of Islamic banking and finance sector. Some discuss particular technical and operational aspects of Islamic financial institutions including *takaful*. In addition, papers on Islamic economics, Islamic corporate social responsibility or CSR, and Islamic microfinance offer conceptual underpinnings of the Islamic moral economy. Furthermore, professional papers detail the reflections of those involved in the industry on some of the issues discussed above.

Izhar and Hassan in their paper examine operational risk in Islamic banks in a structured manner and lay out some issues that are specific to Islamic financial institutions along with others that are common with conventional institutions. In the following article, Chusaini and Ismal explore the credit risk management practices in Indonesian Islamic banking industry and document the effective risk management practices of the industry players and provide suggestions for further improvements. Khafafa and Shafii shift the research orientation to demand conditions of Islamic banking industry, as they explore and analyze the customer satisfaction in Libyan Islamic commercial banks. Their attempt to provide empirical evidence for the relationship between customers' satisfaction and perceived service quality should be of interest to the banks themselves as well as the policy makers in the country.

This special issue has a number of empirical papers on the experience of Islamic banking, or as it is called 'participation banks' in Turkey, as Turkey has recently made important inroads in developing its Islamic finance industry after a rather long stagnation period. The first empirical paper in this section is by Asutay and Ergec, who conduct a comparative study across countries and industries in their paper analyzing the money supply and bank money creation in Islamic and conventional banking industries in Turkey and Malaysia. The dynamics governing both sectors yield important clues particularly for policy makers in each country. In the second empirical study, Aysan, Disli and Ozturk analyze the impact of a regulatory change on the competitiveness of Islamic banking industry in Turkey. The surprising outcome tells that the Islamic banking industry has turned more monopolistic as they have become more integrated with conventional banking. In using primary data to further explore Turkish case, Savaşan, Saraç and Gürdal utilize a survey of institutional customers of Islamic banking in Turkey in the case of Sakarya to explore the demand conditions and propose solutions to the demand side problems. Last among studies on Turkey's case, Kansoy and Karlioglu discuss how Islamic finance practice may help the aspirations of Turkish government to turn Istanbul into a global financial hub.

The second section of the special issue is comprised of two studies on Islamic economics: one on development issue on a philosophical level and the other methodologies of Islamic economics and jurisprudence. Zaman, in reflecting on the relative underdevelopment in the Muslim world, lays bare the misconceptions about the meaning of economic development and debunks Western imposed myths and their misplaced superiority complex with the objective of constructing an authentic development strategy based on Islamic norms. In his paper, Yas provides a brief anthology of various schools of thought on methodological approaches in understanding Islamic economics. The study explores and analyses advantages and shortcomings of each approach thoroughly and opens up the discussion on how to approach the modern problems the Islamic finance industry is currently facing.

In order to disseminate knowledge on the particular aspects of Islamic finance, this special issue also comes with a number of conceptual and issue oriented surveys in Islamic finance. Mohammed provides a systematic analysis of liquidity risk and its management in Islamic financial institutions, through which he explores the developing liquidity instrument opportunity space for Islamic banks with the help of new product innovation. AlNemer explores an important yet underexposed financial product; *takaful*, which is an insurance policy that complies with Islamic law. He presents the fundamental issues such as different models as observed in the industry, but also draw on regulative aspects of *talaful*. In shifting the attention from banks and financial issues to developmentalism, Riwajanti aims to demonstrate the potential of Islamic microfinance as an alternative tool for poverty alleviation, thus serving the developmentalist objectives of the industry, by which she presents a number of Islamic finance models in microfinance. To further shed light on the aspirational dynamics of Islamic economics and finance, Platonova explores and explains the Islamic perspectives on Corporate Social Responsibility (CSR) and social justice as an alternative to the Western constructs, in which various models are also discussed alongside rationalising CSR through the foundational dimensions of Islamic moral economy.

Market practitioners have also contributed to this special issue via their professional perspectives on the current state of affairs and what future holds for the Islamic finance industry. Ulus defines *sukuk* as a *Shari'ah* compliant fixed income product and discusses its considerable and growing presence in the global financial market. Onal provides a professional look at the liquidity issue in Islamic financial industry and institutional efforts such as International Islamic Liquidity Management Corporation for its effective management. Lastly, Dar provides valuable insight as to how Turkey can become the next global hub for Islamic banking and finance through favourable regulatory environment and education.

It is expected that the papers presented in this special issue will be of use to many stakeholders of the industry but also can help the sceptics to revisit the issues. Empirical and conceptual papers respond to market conditions and developing intellectual acumen. In other words, while it is essential that the current practice of the sector should be explored and examined, Islamic moral economy related theoretic knowledge should also be developed to inform the market practices which may deviate from its social optimality. We hope this special issue on Islamic finance can contribute to both of the aims in its way.

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Applying Core Principles of Risk Management in Islamic Banks' Operational Risk Analysis

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Abstract

Identifying operational risk in Islamic banks is a challenging task due to various components it entails. An analysis of operational risk management, therefore, should not be considered as disjointed tasks. On the contrary, it should be viewed as a structured process in which operational risk hazards, events, and losses are integrated in such a manner that will help management of an Islamic bank develop a classification based on a root cause analysis. Thus, by linking causation to relevant business activities, the structure could then be used as a foundation for an effective operational risk management. This is the first main issue which is theoretically addressed by this paper. The subsequent main issue elucidated in the paper is the various dimensions of operational risk in major Islamic financial contracts and the mitigation methods in operational risk.

Introduction

In Islamic banking sphere, the need to cater operational risk issue has been discussed by Khan and Ahmed (2001), Sundararajan and Errico (2002), Hossain (2005), Archer and Haron (2007), Iqbal and Mirakhor (2007), Akkizidis and Kumar (2008), and Izhar (2010). Identifying operational risk exposures in Islamic banks can be somewhat a daunting task since there are numerous components which need to be thoroughly analysed. It does not come as a surprise, therefore, that the magnitude of

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operational risk is perceived to be relatively higher than credit risk and market risk due to its complexities and a wide range of its constituents coupled with some peculiar features in Islamic financial contracts.

It is therefore important to develop a structured framework that the management of an Islamic, particularly for its chief risk officer to identify what constitutes operational risks and how it would affect the bank's performance. Thus, using risk management approach, this paper attempts to contribute to the theoretical development of operational risk analysis by firstly presenting the arguments as to why Islamic banks have a distinct operational risk aspect, as compared to conventional banks. The paper also sheds light upon operational risk issues from a regulatory point of view, namely Basel and IFSB. The following section discusses how to identify and conduct an integrated analysis in operational risk management by using core principles of risk management framework. Methods of mitigating operational risk are discussed in the last section.

Operational Risk Exposures in Islamic Banks

As a modern form of *jahbadh*[1], an Islamic bank is an institution offering financial services which conforms with *Shariah*. A set of shariah principles governing the operations of Islamic banks are (i) prohibition of dealing with interest (riba); (ii) financial contracts must be cleared from contractual uncertainty (*gharar*); (iii) exclusion of gambling (*maysir*) in any financial activity; (iv) profit must not be originated from *haram* economic and financial activities (prohibited industries such as those related to pork products, pornography, or alcoholic beverages); (v) each financial transaction must refer to a tangible, identifiable underlying asset; and (vi) parties to a financial transaction must share in the risks and rewards attached to it. The principles mentioned above must be, conceptually, inherent in Islamic banks, in order to distinguish them from conventional banks.

With regard to operational risk, Islamic banks face the same challenges as conventional ones, to the degree that they offer financial services in various banking activities (Archer and Haron, 2007; Hossain, 2005). At this state, the challenge is impartially similar for all financial intermediaries, whether *shariah*-compliant or not. Similar to the conventional banks, risk management in Islamic banks aims at identifying, measuring, controlling and monitoring different types of risks.

Nevertheless, the challenges are more sophisticated for Islamic banks since the financial activities and the features of the financial contracts are substantially different. Islamic Financial Services Board (IFSB) clearly mentions in its publication that Islamic banks are exposed to "a range of operational risks that could materially affect their operations" (IFSB, 2007a: 22). Further, it is argued that operational risks are likely to be more significant for Islamic banks due to their specific contractual features (Fiennes, 2007; Greuning and Iqbal, 2008; Iqbal and Mirakhor, 2007; Khan and Ahmed, 2001; Kumar, 2008; Sundararajan and Errico, 2002; and Sundararajan, 2005).

Unlike the Basel 2's definition on operational risk which states "operational risk is the risk of loss resulting from inadequate or failed internal processes, people or system, or from external events" (BCBS, 2001: 2); in Islamic banks, operational risk is associated with the loss resulting from "inadequate or failed internal processes, people and system, or from external events, including losses resulting from *Shariah* non-compliance and the failure in fiduciary responsibilities" (IFSB, 2005a: 26). It is understood that the definition of operational risk in Islamic banks entails legal risk (Archer and Haron, 2007; Cihak and Hesse, 2008; Djojosugito, 2008, Fiennes, 2007; Khan and Ahmed, 2001; and Sundararajan, 2005), and also reputational risk (Fiennes, 2007; Akkizidis and Kumar, 2008; Standard & Poor's, 2008). The foremost distinctive feature of this definition, as compared to the definition by Basel 2, is the inclusion of *Shariah* non-compliance risk and fiduciary risk. As a matter of fact, *Shariah* non-compliance risk is considered to have a significant portion in operational risk (IFSB, 2007b: 6).

Shariah non-compliance risk is the risk arising from Islamic banks' failure to comply with the *Shariah* rules and principles determined by the Shariah Board or the relevant body in the jurisdiction in which the Islamic bank operates (IFSB, 2005a). The failure to comply with such principle will result in the transaction being cancelled, and hence the income or loss cannot be recognised. Moreover, fiduciary risk is the risk that arises from Islamic banks' failure to perform in accordance with explicit and implicit standards applicable to their fiduciary responsibilities (IFSB, 2005a).

Therefore, a failure in maintaining fiduciary responsibilities will result in the deterioration of Islamic banks' reputation (Hamidi, 2006). A reputational damage could eventually cause a withdrawal of funds which would result in a liquidity crisis. It could also make customers stop requesting financing from Islamic banks, triggering a downturn in profitability. Therefore, in order to keep good reputation, it is suggested that Islamic banks need to do two things; firstly, to ensure that their financial products are *Shariah* compliant (Greuning and Iqbal, 2008; and Iqbal and Mirakhor, 2007), secondly, to effectively maintain their fiduciary roles (Muljawan, 2005).

As such, it elucidates why operational risk management in Islamic banks is not similar to that in conventional banks. There are a number of dimensions need to be added in the analysis. Although it is argued earlier that the challenges are somewhat similar, they are only to the extent that Islamic banks and conventional banks are dealing with various banking activities. To a greater extent, operational risk management in Islamic banking requires more thorough understanding of the sources of operational risk from which the loss could occur. It is, therefore, proposed that operational risk exposures in Islamic banks could stem from the following main sources: (i) People; (ii) Systems; (iii) Process; and (iv) External events.

People

This is the most dynamic of all sources of operational risk where the true cause of many operational losses can be traced to people failure. People risk refers to losses coming from events such as human errors, frauds, violations of internal rules and procedures (unauthorized trading, insider dealing) and more generally problems of incompetence and negligence of the financial institution human resources (Akkizidis and Kumar, 2008). Another aspect which has to be taken into consideration is that whether the risk of a loss is intentional or unintentional. Unfortunately, as Akkizidis and Kumar (2008) contend, the largest amount of losses comes from intentional activities such as fraud and unauthorised trading. For instance, an internal control problem cost the Dubai Islamic Bank US$ 50 million in 1998 when a bank official did not conform to the bank's credit terms. This also resulted in a run on its deposits of US$ 138 million, representing 7% of the bank's total deposits, in just one day (Warde, 2000: 155). Another case involving a large unauthorised loan, around US$ 242 million, was also caused by bank official of the Dubai Islamic Bank and West African tycoon Foutanga Dit Babani Sissoko.

The thriving development of Islamic banking industry, unfortunately, has not corresponded with the number of people who have credentials in running and directing the business. This issue has been highlighted by Aziz (2006), Edwardes (2002), Jackson-Moore (2007), Khan (2004), Khan and

Ahmed (2001), and Kumar (2008), and Nienhaus (2007). The dimension of people risk in Islamic banks is understandably wider than in conventional ones since the personnel of Islamic banks' personnel are required to be well-versed in both, conventional banking products and their status in relation to Islamic requirements (Aziz, 2006; Ebrahim, 2007; Nienhaus, 2007). There is a dire need that Islamic banking industry must be equipped with a new breed of innovators, risk managers, regulators and supervisors who have the right blend of knowledge of finance and the understanding of the *Shariah* (Aziz, 2006).

Furthermore, they should be aware of the existing Islamic alternatives and their commercial advantages and disadvantages compared to the conventional products (Nienhaus, 2007). A shortage in skilled bankers with such requirements aforementioned above, will undoubtedly lead to a higher people risk (Jackson-Moore, 2007). In other word, inadequately trained staff or incapable personnel will expose Islamic banks unnecessarily to operational risk. In response to a very demanding industry, staffs of Islamic banks must be able to design Shariah compliant financial innovations in order to meet the diversified needs of the clients and to match the ever increasing scope of conventional techniques, procedures, and products. More importantly, despite the fact of such challenges, staffs of Islamic banks should be able to create financial contracts which are more than just legally interest free. In other words, skilled staffs of Islamic banks will ensure that the products are efficient as well as *Shariah*-compliant. Unskilled staffs can cause the product to be, either illegitimate according to *Shariah* or inefficient.

A fraud case in the Dubai Islamic Bank as mentioned above shows that an institution called Islamic bank is not free from fraud, whether intentional or unintentional. Akkizidis and Kumar (2008) suggest that financial institutions should establish appropriate system and thorough control for the management of operational risks that may arise from employee. Hence, the following direction can be established (Akkizidis and Kumar, 2008: 194-195):

- A selection of employees that respect and follow the *Shariah* principles
- A separation of the employees' duties
- An internal supervision of the employees' performances
- Well established policies that are complying with the *Shariah* principles and are well known by all employees

- Training process to direct the employees in the process of the risk management
- A transparent reward and punishment mechanism.

At the current state, it is understood that people risk can contribute to operational risks substantially. One of the reasons is because of the lack of people who are adequately trained in both modern financial transactions and applied *fiqh muamalah*. In most cases, Islamic banks hire shariah scholars who hardly understand the complexity of modern financial transactions. On the other hand, it is also very difficult to find financial economists who are knowledgeable in applied f*iqh muamalah*.

Systems

In an advanced financial industry, an Islamic bank's operations are very much dependent on its technological system. Its success depends, in great part, on its ability to assemble increasingly rich databases and make timely decisions in anticipation of client demands and industry changes. The advanced use of information technology (IT) has also brought a new facet in the current competition of Islamic banking industry. It is often that a success of an Islamic bank's business is determined by the ability to capitalise the use of an information technology in different ways. An inability to keep up with the advanced use of an information technology could cause an Islamic bank fall behind its competitors. Therefore, every Islamic bank must be committed to an ongoing process of upgrading, enhancing, and testing its technology, to effectively meet (Chorafas, 2004: 91); (a) sophisticated client requirements, (b) market and regulatory changes, and (c) evolving internal needs for information and knowledge management.

Chorafas (2004) argues that a failure to respond to the above prerequisites could increase an exposure to operational risk related to IT. In addition, the use of software and telecommunications systems that are not tailored to the need of Islamic banks could also contribute to technology risk, as well as many other internal such as such as human error, internal fraud through software manipulation (Chorafas, 2004: 91), programming errors, IT crash caused by new applications, incompatibility with the existing systems, failures of system to meet the business requirements (Akkizidis and Kumar, 2008: 191), external fraud by intruders; obsolescence in applications and machines, reliability issues, mismanagement, and the effect of natural disasters.

It is clear from the explanation above that the extensive use of an information technology could increase IT related operational risk in number and severity originating from internal as well as external events.

However, high technology allows a visualisation which turns numbers into graphs and images. Unfortunately, only few financial institutions have the ability to capitalise the best that the technology can offer (Chorafas, 2004). Spending big sums of money on technology without the corresponding return on investment (ROI) is also an indication of an IT-related operational risk.

Process

Financial institutions operate a myriad of processes to deliver their products and activities to their customers. Process risk includes the losses that originate from inadequacies in the internal processes and procedures. Examples include events such as the violation of the information system security due to insufficient controls (security risk) errors in the execution and/or settlement of securities and foreign currency transactions (transaction and settlement errors) inadequate record-keeping, accounting and taxation errors, mispricing and errors in risk measurements due to problems in the internal models and methodologies (model risk) and breaches of mandate.

In the context of Islamic banking, another dimension of process risk is the need to remain compliant with Shariah principles in the process and procedures of structuring Islamic financial transactions. A failure to fulfil such requirement may lead to Shariah non-compliance risk. IFSB guiding principles of risk management for institutions offering Islamic financial services—other than insurance institutions, clearly mentions the definition of Shariah non-compliance risk. It is the risk which arises from "IIFSs'[2] failure to comply with the Shariah rules and principles determined by the Shariah board of the IIFS or the relevant body in the jurisdiction in which the IIFS operate" (IFSB, 2005a: 26). For Islamic banks, to be Shariah compliant is paramount. According to IFSB Principle 7.1, Islamic banks shall have in place adequate system and controls, including Shariah Board/Advisor, to ensure compliance with Shariah rules and principles (IFSB, 2005a: 27). Such compliance requirements must be pervasively infused throughout the organisation as well as in their products and activities. Shariah compliance is considered by IFSB as a higher priority in relation to the other identified risks, since violation of Shariah principles will result in the transactions being cancelled or income generated from them shall be considered as illegitimate.

The need to ensure compliance with Shariah in operational risk management is vital (Aziz, 2006) and it must encompass the products, activities, and contract documentation—with regard to formation, termination and elements which might possibly affect contract performance such as fraud and misrepresentation. Furthermore, the degree of Shariah compliance, as IFSB (2005a) suggests, has to be reviewed, at least, annually which can be performed by a credible party, either from a separate Shariah control department or as part of the existing internal and external audit. The main objective is to ensure that (a) the nature of Islamic banks' financing and equity investment; and (b) their operations are executed in adherence to the *Shariah* principles.

In the event that *Shariah* non-compliance occurs, either in the products or activities, Islamic banks need to keep record of the profits out of it. The record will help Islamic banks assess the probability of similar cases arising in the future. Further, historical reviews and data of potential areas of *Shariah* non-compliance will enable Islamic banks to make an assessment on the potential profits which cannot be recognised as legitimate profits. In order word, potential loss could be managed, hence, reduced to a minimum level.

With respect to *Shariah* requirements in financing contracts, albeit the diversity of interpretations prevalent in the industry, Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has already issued its latest *Shariah* standard that could be referred to by Islamic banks. In sum, *Shariah* compliant financing—in six different contracts, needs to fulfil the following *Shariah* requirements (AAOIFI, 2005):

(a) *Murabahah* and *Ijarah* contracts:

- The asset is in existence at the time of sale or lease or, in Ijarah, the lease contract should be preceded by acquisition of the usufruct of the leased asset;
- The asset is legally owned by Islamic banks when it is sold;
- The asset is intended to be used by the buyer/lessee for activities or business permissible by *Shariah*; if the asset is leased back to its owner in the first lease period, it should not lead to contract of *'inah*, by varying the rent or the duration;

- In the event of late payment, there is no penalty fee or increase in price in exchange for extending or rescheduling the date of payment of accounts receivable or lease receivable, irrespective of whether the debtor is solvent or insolvent.

(b) *Salam* and *Istisna'* contracts:
- A sale and purchase contract cannot be inter-dependent and inter-conditional on each other. This is for the case of *salam* and parallel *salam* or istisna and parallel istisna';
- It is not allowed to stipulate a penalty clause in respect of delay in delivery of a commodity that is purchased under salam contract. However, it is allowed under istisna' or parallel *istisna'*;
- The subject matter of an *istisna'* contract may not physically exist upon entering into the contract.

(c) *Musharakah* and *Mudarabah* contracts:
- The capital of the Islamic banks is to be invested in *Shariah* compliant investments or business activities;
- A partner in *musharakah* cannot guarantee the capital of another partner or a mudarib guarantees the capital of the mudarabah;
- The purchase price of other partner's share in a *musharakah* with a binding promise to purchase can only be set as per the market value or as per the agreement at the date of buying. It is not permissible to stipulate that the share be acquired at its face value.

Clearly, it is vital for Islamic banks to abide by the *shariah* principles in every aspect of their financial transactions. In addition to that, the process of structuring the contracts is also very important. In other word, sequence in structuring certain financial products could determine the degree of *shariah* compliance, since a few contracts could be used as legal devices to circumvent certain *shariah* principles.

External Events

This source includes all losses a financial institution may suffer as a consequence of a wide range of external events which typically are not under the control of the management. These include events such as changes in the political, regulatory and legal environment that negatively affect the financial institution profitability, operational failures at suppliers or outsourced operations, criminal acts such as theft vandalism robbery or terrorism and natural events such as fire, earthquake, floods and other natural disasters.

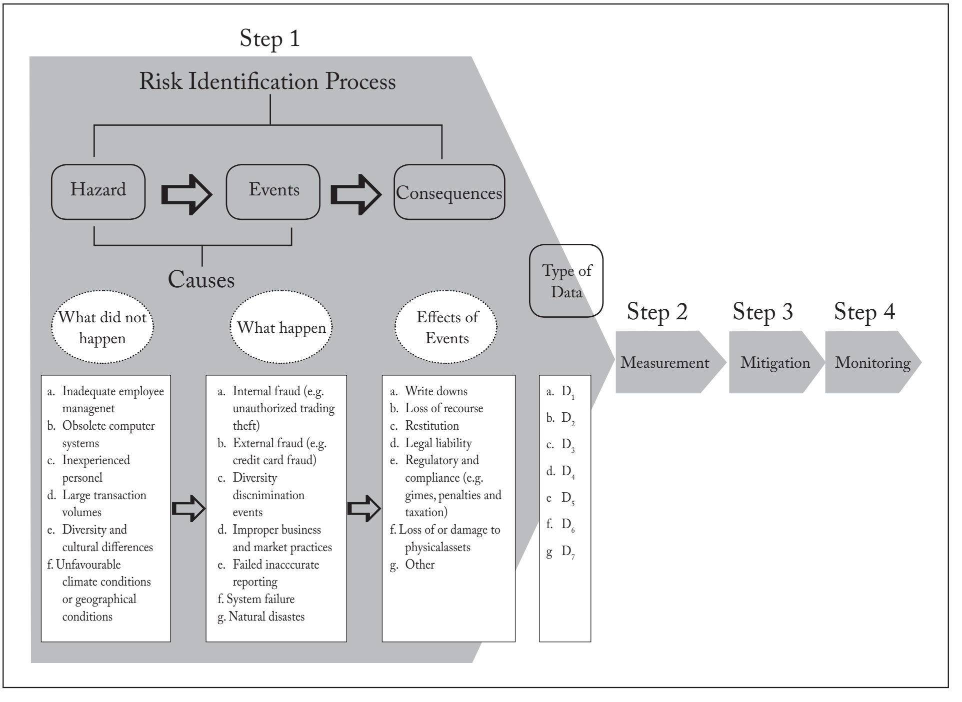
In the area of legal risk in Islamic banking for instance; the impacts of which on Islamic banks are substantial and cannot be neglected (Cihak and Hesse, 2008; Djojosugito, 2008; Hassan and Dicle, 2005; Iqbal, 2005; Kahf, 2005; Kumar, 2008; Nienhaus, 2005; and Sundararajan, 2005). Legal risk may arise from uncertainty in laws (Kumar, 2008), lack of reliable legal system to enforce financial contracts (Djojosugito, 2008; Iqbal, 2005; Sundararajan and Errico, 2002; and Sundararajan, 2005), legal uncertainty in the interpretations of contracts (Cihak and Hesse, 2008), the legality of financial instruments (Djojosugito, 2008), lack of availability of legal experts (Kumar 2008), and exposure to unanticipated changes in laws and regulations (Djojosugito, 2008). Moreover, it is argued that some operational aspects of Islamic banking activities are not sufficiently covered by laws, which in turn, results in the exposure of legal risk to Islamic banks (Djojosugito, 2008). It stems from the fact that most of Islamic banks, at the current stage, operate within similar legal and business environments (Hassan and Dicle, 2005; and Kahf, 2005). In addition to that, a number of inevitable separate contracts in Islamic banking products could contribute to additional legal risks (PWC, 2009). For example, in the case of *murabaha* transaction, the bank has to buy an item and then sell it on under different payment terms—each step takes time and involves a fresh contractual agreement which magnifies the scope for disagreements and complications.

Uncertainty in regulation may also account for legal risk if such regulatory changes affect the legality of certain Islamic financial instruments. This is the case in Indonesia where the law views some of *mudarabah* bonds issued as debt which in effect is guaranteed by the patrimony of *mudarib* (Djojosugito, 2008). While *shariah* prohibits such recourse, the law will not uphold the *shariah* prohibition.

Risk Management Principles in Operational Risk Analysis

Confusion usually arises in the operational risk because of the distinction between risk type (or *hazard* type), event type, and *consequence* (or *loss* type). The following figure will help in clarifying such confusion by methodically differentiating *hazard, event type* and *consequences*. Mori and Harada (2001), Alvarez (2002), and Dowd (2003) suggest that the distinction between the three is comparable to cause and the effect. *Hazard* constitutes one or more factors that increase the probability of occurrence of an event; *event* is a single incident that leads directly to one or more effects (e.g. losses); and loss constitutes the amount of financial damage resulting from an event. When banks record their operational loss data, it is very essential to record it separately according to event type and loss type, and precisely identify the risk type as well.

Figure 1: Application of Risk Management Principles in Operational Risk Analysis



Mori and Harada (2001) shows how operational losses would occur in a process called 'cause-effect' relationship between *hazard*, *event*, and *loss*. *Loss* is effect of *event* while *event* is cause of *loss*. Yet, *event* is effect of *hazard* while *hazard* is cause of *event*. In other words, every *loss* must be associated with an *event* that caused the *loss*, while every *event* must be associated with one or multiple *hazards* that caused the *event*.

The figure above espouses the core principles of risk management process consisting of four main steps, namely *identification*, *measurement*, *mitigation*, and monitoring; which in this paper, is attributed IM_3. Identification process essentially stems from characterising *what did not* *happen* (*hazards*); which would cause a range of events. Such events would subsequently have a wide range of consequences which, if done properly and meticulously based on their respective nature, will help in classifying the data needed in the measurement process.

A thorough measurement process would enable chief risk officer to reach at a close proximity of operational risk exposures which would immensely help in selecting mitigation methods.

The last step (step 4) is monitoring, which Blunden and Thirlwell (2010) contends that it should be risk-based. A significant part of monitoring is to re-assess, on a regular basis, the risks at both management and operational level.

Operational risk hazards, events, and losses are usually associated with internal control weaknesses or lack of compliance with existing internal procedures as well as with the shariah principles. Such a lack of compliance can be found in all areas of an institution and is mainly caused by the combined actions of people, technological systems, processes, and some unpredictable events. It is proposed that an Islamic bank focuses on root causes as opposed to effects. When a risk event is formulated, the causes or originating sources could be identified, and hence, what consequences that would take place could also be identified. The resulting consequences if the risk is to be 'accepted', 'avoided', or 'mitigated' must also be understood.

An analysis of operational risk management should not be thought of as disjointed tasks; instead, it should be viewed as a structured process in which relevant risks and control information are integrated. This is an important message of the whole process depicted in figure 1 above. Such structured approach will help management of an Islamic bank develop a classification based on a root cause analysis which can eventually be captured in the loss event database. Thus, by linking causation to relevant business activities, through correlation analysis for instance, the structure could then be used as a foundation for an effective operational risk management.

Operational Risks in Islamic Financial Contracts

After identifying various aspects of operational risks in relation to Islamic banking, this section discusses different dimensions of operational risk in different types of Islamic financial contracts. As can be seen in table 1, the five dimensions of operational risk are *Shariah* compliance risk (*SR*), fiduciary risk (*FR*), people risk (*PR*), legal risk (*LR*), and technology risk

(*TR)*. The first three dimensions are, by nature, internally inflicted; while the fourth one is naturally from external source. As for technology risk (*TR*); it can originate from either internal or external operational failures.

Murabahah

Murabahah is "selling a commodity as per the purchasing price with a defined and agreed profit mark-up" (AAOIFI, 2005). This mark-up may be a percentage of the selling price or a lump sum. Moreover, according to AAOIFI standard (2005), this transaction may be concluded either without a prior promise to buy, in which case it is called ordinary *murabahah*, or with a prior promise to buy submitted by a person interested in acquiring goods through the institution, in which it is called a "banking *murabaha*", ie. *murabaha* to the purchase orderer. This transaction is one of the trust-based contracts that depends on transparency as to the actual purchasing price or cost price in addition to common expenses.

Murabahah is the most popular contract in terms of its use, since most of Islamic commercial banks operating worldwide rely on this contract in generating income. Different dimensions of operational risk which can arise in murabahah transaction are as follows:

- *Shariah compliance* risk (*SR*); may arise if the Islamic banks give money, instead of commodity, which will then result in the exchange of money and money. This is prohibited in *Shariah*, since the exchange of money with money, plus additional amount above the principal and paid in different time will tantamount to riba. AAOIFI *Shariah* standard (2005) also requires Islamic banks to own, legally, the commodity before they sell it to the customers. It is important to note that the sequence of the contract is very central in *murabahah* transaction. Inability or failure to conform with the sequence and shariah requirement will result in the transaction to be deemed illegitimate.
- *Fiduciary risk* (*FR*); this risk arises due to the inability to meet the specified commodity stipulated in the contract.
- *People risk* (*PR*); the risk can result from two sides, seller as well as buyer. *PR* from the seller side occurs if Islamic banks fail to deliver the specified product agreed in the contract on due date, while PR from the buyer side takes place when the buyers does not keep their promise to buy the commodity. This can happen in the binding murabaha contract.

Table 1. The Dimensions of Operational Risk in Islamic Financial Contracts

Contracts	Internal Risks				External Risks	
	***Shariah* Compliance Risk (*SR*)**	**Fiduciary Risk (*FR*)**	**People Risk (*PR*)**	**Technology Risk (*TR*)**	**Legal Risk (*LR*)**	**Technology Risk (*TR*)**
Murabaha	• Exchange of money and commodity needs to be ensured • In the event of late payment, penalty must be avoided as it will tantamount to riba.	Inability to meet the specified product stipulated in the contract	Fail to deliver the product	Incompatibility of the new accounting software	Products to be sold must be legally owned by the bank	System failures and external security breaches
Salam	• Final payment of monetary rewards must be concluded in advance • Penalty clause is illegitimate in the event of seller's default in delivering the goods • In parallel *salam*, execution of second *salam* contract is not contingent on the settlement of the first *salam* contract	• Inability to meet the specified product stipulated in the contract. • Delivery of inferior goods cannot be accepted	Mismatch in the commodity's specification due to inability of seller to provide the exact product mentioned in the contract.	Incompatibility of the new accounting software	Goods must be delivered when it is due, as agreed in the contract	Specification mismatching in commodities productions agreed in the contract
Istisna	• Should not be used as a legal device; e.g. the party ordering the product to be produced is the manufacturer himself • In parallel *istisna'*, contracts should be separated to avoid two sales in one deal	Need to ensure the quality standards of the products	Inability to deliver the product on time	Incompatibility of the new accounting software	Disagreement with the sub-contractor or the customer in the event of remedying the defects	Specification mismatching in commodities productions agreed in the contract
Ijara	• Need to ensure that leased asset is used in a *Shariah* compliant manner • In *ijarah muntahia bittamleek*, an option to purchase cannot be enforced.	Major maintenance of the leased asset is the responsibility of the banks or any party acting as lessor.	Lessor needs to understand that in the event of payment delay, rental due cannot be increased as clearly exemplified by AAOIFI	Incompatibility of the new accounting software	Enforcement of contractual right to repossess the asset in case of default or misconduct by the lessee	Losses of information on the leased assets specified in the contract due to external security breaches
Musharakah	Profit allocation is based on actual profit, not expected profit	Inadequate monitoring of the financial performance of the venture	Lack of technical expertise in assessing the project	Incompatibility of the new accounting software	A mixture of shares in one entity may lead to legal risk if the regulation does not facilitate such action	Losses of information on the projects specified in the contract due to external security breaches
Mudarabah	Profit allocation is based on actual profit, not expected profit	Inadequate monitoring of the business	Inability to provide regular and transparent financial performance of the project	Incompatibility of the new accounting software	Misinterpretation of civil law upon implementation of *Shariah* compliant *mudaraba*	Losses of information on the projects specified in the contract due to external security breaches

Source: Izhar (2010: 37)

- *Legal risk* (*LR*); profit originated from murabahah can not be equated with interest, although it looks similar. The main difference is because the resulting profit is tied with the underlying commodity. This might create legal problem as in certain countries, the regulators only give limitation on interest rate, not profit rate. Hence, the absence of so called 'profit rate cap' has the potential to crate legal problems if there is any dispute. Another potential problem can occur at the contract signing stage, since the contract requires the Islamic bank to purchase the asset first before selling it to the customer; the bank needs to ensure that the legal implications of the contract properly match the commercial intent of the transactions.
- *Technology risk* (*TR*); may result from an incompatibility of the new accounting software or an external system failure.

Salam and Parallel Salam

AAOIFI *Shariah* standards (2005) define *salam* as a transaction of the purchase of a commodity for the deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the *salam* capital, is paid at the time of contracting while the delivery of the item to be sold, know as *al-muslam fihi* (the subject matter of a *salam* contract), is deferred. The seller and the buyer are known as *al-muslam ilaihi* and *al-muslam* or *rabb al-salam* respectively. *Salam* is also known as *salaf*. Parallel *salam* occurs when the seller enters into another separate salam contract with a third party to acquire goods, the specification of which corresponds to that of the commodity specified in the first salam contract (AAOIFI, 2005).

- *Shariah compliance risk* (*SR*); one of the very central conditions in *salam* contract is that the payment of *salam* capital must be paid full in advance. If payment is delayed, the transaction is not called *salam* (AAOIFI, 2005: 172). Any delay in payment of the capital and dispersal of the parties renders the transaction a sale of debt for debt, which is prohibited, and the scholars agreed on its prohibition (AAOIFI, 2005: 172). Another aspect, which might lead to *SR* may also occur in parallel *salam*; this will take place if the execution of the second salam contract is contingent on the execution of the first *salam* contract. Penalty clause is also not allowed, in the event of a seller's default in delivering the good. The basis for not allowing penalty in *salam* is because *al-muslam fihi* (the subject matter of a *salam* contract) is considered to be a debt; hence it is not permitted to stipulate payment in excess of the principal amounts of debt (AAOIFI, 2005: 173).

- *Fiduciary risk* (*FR*); *salam* is generally associated with the agricultural sector. The buyer must either rejects goods of an inferior quality to that specified in the contract, or accept them at the original price. In the latter case, the goods would have to be sold at a discount (unless the customer under a parallel *salam* agreed to accept the goods at the originally agreed price).
- *People risk* (*PR*); can arise due to a seller's default in delivering the commodity or due to the commodity's specification mismatching. Financial institutions may minimise such type of operational risks by asking from the seller guarantees that they are following a quality management system or following any standard system, or by asking for references on past promises on salam contract or by collateralising their losses via insurance policies.
- *Legal risk* (*LR*); Islamic banks may face legal risk if the goods can not be delivered at the specified time (unless the customer under parallel salam agrees to modify the delivery date).
- *Technology risk* (*TR*); may result from an incompatibility of the new accounting software or the system fails to specify precisely the commodities agreed in the contract.

Istisna' and Parallel Istisna'

Istisna' is another type of forward contract, but the role of an Islamic bank as a financial intermediary differs from that in a *salam* contract. In this case, the bank contracts to supply a constructed asset (such as a building or a ship) for a customer. In turn, the bank enters into a parallel *istisna'* with a sub-contractor in order to have the asset constructed. Its reliance on the parallel istisna counterparty (the sub-contractor) exposes it to various operational risks, which need to be managed by a combination of legal precautions, due diligence in choosing sub-contractors, and technical management by appropriately qualified staff or consultants of the execution of the contract by the sub-contractor. Islamic banks that specialise in istisna' financing may have an engineering department. Risks may include the following:

- *Shariah compliance risk* (*SR*); could arise if Istisna is being used as a legal device for mere interest based financing. For instance, an institution buys items from the contractor on a cash payment basis and sells them back to the manufacturer on a deferred payment basis at a higher price; or where the party ordering the subject matter to be produced is the manufacturer himself; or where one third or more of the facility in which the subject matter will be produced belongs to the customer. All the circumstances mentioned above would make the deal an interest based financing deal in which the subject matter never genuinely changes hands, even if the deal won through competitive bidding. This rule is intended to avoid sale and buy back transactions (bay al-inah). In parallel istisna', the separation of contracts is a must, hence this is not an instance of two sales in one deal, ehich is prohibited.
- *Fiduciary risk* (*FR*); the sub-contractor may fail to meet quality standards or other requirements of the specification, as agreed with the costumer under the istisna' contract.
- *People Risk* (*PR*); this may arise if the Islamic bank may be unable to deliver the asset on time, owing to time overruns by the sub-contractor under the parallel istisna', and may thus face penalties for late completion.
- *Legal risk* (*LR*); Islamic banks may face legal risk if no agreement is reached with the sub-contractor and the customer either for remedying the defects or for reducing the contract price.
- *Technology risk* (*TR*); may result from an incompatibility of the new accounting software or the system fails to specify precisely the commodities that would be produced in the contract.

Ijarah and Ijarah Muntahia Bittamleek

In simple terms, an ijarah contract is an operating lease, whereas ijarah muntahia bittamleek is a lease to purchase. While operational risk exposures during the purchase and holding of the assets may be similar to those in case of murabahah, other operational risk aspects include the following:

- *Shariah compliance risk* (*SR*); the Islamic banks need to ensure that the asset will be used in a *Shariah* compliant manner. Otherwise, it is exposed to non-recognition of the lease income as non-permissible.

- *Fiduciary risk* (*FR*); major maintenance is the responsibility of an Islamic bank as a lessor, as directed by AAOIFI *Shariah* standards (2005: 154). In addition to that, it is the duty of the lessor to ensure that the usufruct is intact, and this is not possible unless the asset is maintained and kept safe so that the lessor may be entitled to the rentals in consideration for the usufruct. Thus, deficiencies in maintaining such responsibility can be deemed to be sources of *FR* in ijarah contract.
- *People risk* (*PR*); lessor is not allowed to increase the rental due, in case of delay of payment by the lesse, this is what AAOIFI (2005) clearly exemplifies. Misunderstanding of this principle by the staff is a source of losses caused by PR, because the income generated from this, is not permissible from *Shariah* point of view.
- *Legal risk* (*LR*);the Islamic bank may be exposed to legal risk in respect of the enforcement of its contractual right to repossess the asset in case of default or misconduct by the lessee. This may be the case particularly when the asset is a house or apartment that is the lessee's home, and the lessee enjoys protection as a tenant.
- *Technology risk* (*TR*); may occur due to an incompatibility of the new accounting software or losses of information on the leased assets due to external security breaches.

Musharakah

Musharakah is a profit and loss sharing partnership contract. The Islamic bank may enter into a *musharakah* with a customer for the purpose of providing a *Shariah* compliant financing facility to the customer on a profit and loss sharing basis. The customer will normally be the managing partner in the venture, but the bank may participate in the management and thus be able to monitor the use of the funds more closely. Typically, a diminishing *musharakah* will be used for this purpose, and the customer will progressively purchase the bank's share of the venture. Operational risks that may be associated with *musharakah* investments are as follows:

- *Shariah compliance risk* (*SR*); the source of *SR* may arise due to the final allocation of profit taking place based on expected profit. AAOIFI (2005: 205) commands that it is necessary that the allocation of profit is done on the basis of actual profit earned through actual or constructive valuation of the sold assets.

- *Fiduciary risk* (*FR*); any misconduct or negligence of the partners are the sources of *FR*. This can happen in the absence of adequate monitoring of the financial performance of the venture.
- *People risk* (*PR*); lack of appropriate technical expertise can be a cause of failure in a new business activity.
- *Legal risk* (*LR*); an Islamic bank which enters into musharakah contract needs to acquire some shares from separate legal entity that undertake Shariah compliant activities. A mixture of shares in one entity may lead to legal risk if the regulation does not allow doing such action.
- *Technology risk* (*TR*); may occur due to an incompatibility of the new accounting software or losses of the precise information on projects undertaken due to external security breaches.

Mudarabah

Mudarabah is a profit sharing and loss bearing contract under which the financier (*rab al mal*) entrusts his funds to an entrepreneur (*mudarib*). The exposure of operational risk in *mudarabah* is somewhat similar to that of musharakah. However, since this type of contract may be used on the assets side of the balance sheet, as well as being used on the funding side for mobilising investment accounts, the operational risk is first analysed from the assets-side perspective and then from the funding side perspective (which is related to fiduciary risk)

Asset-side Mudarabah

Contractually, an Islamic bank has no control over the management of the business financed through this mode, the entrepreneur having complete freedom to run the enterprise according to his best judge judgement. The bank is contractually entitled only to share with the entrepreneur the profits generated by the venture according to the contractually agreed profit sharing ratio. The entrepreneur as *mudarib* does not share in any losses which are borne entirely by the *rab al mal*. The *mudarib* has an obligation to act in a fiduciary capacity as the manager of the bank's funds, but the situation gives rise to moral hazard especially if there is information asymmetry—that is, the bank does not receive regular and reliable financial reports on the performance of the *mudarib*. Hence, in addition to due diligence before advancing the funds, the bank needs to take precautions against problems of information asymmetry during the period of investment.

Funding-side Mudarabah

Profit-sharing (and loss bearing) investment accounts are a *Shariah* compliant alternative to conventional interest-bearing deposit account. Since a *mudarabah* contract is employed between the Islamic bank and its investment account holders, the investment account holders (IAHs) share the profits and bear all losses without having any control or rights of governance over the Islamic bank. In return, the Islamic bank has fiduciary responsibilities in managing the IAHs' funds. The IAHs typically expect returns on their funds that are comparable to the returns paid by competitors (both other Islamic banks and conventional institutions), but they also expect the Islamic bank to comply with *Shariah* rules and principles at all times. If the Islamic bank is seen to be deficient in its *Shariah* compliance, it is exposed to the risk of IAHs withdrawing their funds and, in serious cases, of being accused of misconduct and negligence. In the latter case, the funds of the IAHs may be considered to be a liability of the Islamic bank, thus jeopardising its solvency.

Operational Risk Mitigation Techniques in Islamic Banks

Business Continuity Plan

Different types of incidents such as interruption of IT or communication lines or external event such as terrorism or floods may cause business disruption. Islamic banks should have in place a business continuity plan of the operational process or major work systems to be implemented in case of business disruption. Business continuity plan is used as a safeguard against various risks in order to mitigate the operational risk and curb the possible effects on interested parties. It should include at least the following components:

- An emergency plan that is an operational plan including methods to support, control and remedy various incidents such as fire or floods. It should also include employees evacuation plan and removal plan for important assets. In addition, a detail of loss mitigation measures on personnel, properties and suitable business operations should also be developed.
- A back-up plan and systems, namely an operational plan with detailed methods in selecting options of work system and procedures in order to continue the business.

- A disaster recovery plan describing different procedures to recover damaged conditions to return to normal business operation.

Takaful (insurance)

Takaful can be considered as a key instrument to hedge against operational risk. Elements of operational risk have been insured for some time. Examples include property coverage, fire and fraud. Takaful scheme will provide Islamic banks with the means of taking off their balance sheet and avoiding the significant costs of capital associated with the provisions for risk. Demand for traditional insurance coverage has increased dramatically in recent times as banks wake up to the potential horrors presented by various operational risks. Moreover the market for alternative risk transfer has been growing in recent years. One way to look at the decision making process for operational risk insurance is to categorise by severity and frequency on a risk map. In line with what Basel 2, banks that use advanced measurement approach in calculating the capital charge for operational risk to use insurance as a mitigation technique and the amount of insurance to be deducted from the capital required against operational risk. In this respect, Islamic banks may consider to utilise the service of takaful companies in mitigating some of their operational risks.

Outsourcing

As clearly mentioned in the earlier section that thriving development of Islamic banking industry has, unfortunately, not been matched up with the number of people who have credentials in running and directing the business. The dimension of people risk in Islamic banks is understandably wider than in conventional ones since the personnel of Islamic banks' personnel are required to be well-versed in both, conventional banking products and their status in relation to Islamic requirements (Aziz, 2006; Ebrahim, 2007; Nienhaus, 2007). There is a dire need that Islamic banking industry must be equipped with a new breed of innovators, risk managers, regulators and supervisors who have the right blend of knowledge of finance and the understanding of the *Shariah* (Aziz, 2006).

Furthermore, they should be aware of the existing Islamic alternatives and their commercial advantages and disadvantages compared to the conventional products (Nienhaus, 2007). A shortage in skilled bankers with such requirements aforementioned above, will undoubtedly lead to a higher people risk (Jackson-Moore, 2007). In other word, inadequately trained staff or incapable personnel will expose Islamic banks unnecessarily to operational risk. In response to a very demanding industry, staffs of Islamic banks must be able to design Shariah compliant financial innovations in order to meet the diversified needs of the clients and to match the ever increasing scope of conventional techniques, procedures, and products. More importantly, despite the fact of such challenges, staffs of Islamic banks should be able to create financial contracts which are more than just legally interest free. In other words, skilled staffs of Islamic banks will ensure that the products are efficient as well as *Shariah*-compliant. Unskilled staffs can cause the product to be, either illegitimate according to *Shariah* or inefficient.

For an Islamic bank with a deficiency in skilled staffs, outsourcing has number of advantages such as it will lower transaction costs and added benefits of having people with expertise to do the job and freeing up capital and resources to focus on core business. This would have a positive impact while doing a cost-benefit analysis study of risk mitigation. Proper service level agreements (SLAs) combined with performance benchmarks and independent evaluation can ensure that the impact of operational losses is reduced.

Adequate control policies and procedures

The absence of policies and procedures will likely expose Islamic banks to huge operational risks. It is therefore important for an Islamic bank to mitigate operational risk related to the processes by developing adequate control policies and procedures.

Training

Training is a good tool for mitigating different types of risks as it enhances staff efficiency in Islamic banks and as a result reducing errors. Islamic banks should assign suitable budget for training and carry out different training techniques and strategies to update their staffs with different new issues regarding the financial environment, new products, and new systems.

Conclusion

It has been widely understood that analysing operational risk in financial institutions should thoroughly be carried out. It is mainly because of the various components it carries which, in many cases, has created difficulties in determining the root cause of operational loss. As such, this paper provides a structured framework by adopting core principles of risk management, namely *identification, measurement, mitigation* and *monitoring* (IM_3) in analysing operational risks. Such framework will help the management of an Islamic bank, particularly its chief risk officer to clearly define which components that can be characterised as hazards, events, or losses. As a consequence, the causes or originating sources of loss could be identified, and hence, what consequences that would take place could also be recognised.

The paper also vividly explicates five dimensions of operational risk in major Islamic financial contracts that need to be taken care of. The five dimensions are are Shariah compliance risk (*SR*), fiduciary risk (*FR*), people risk (*PR*), legal risk (*LR*), and technology risk (*TR*). The first three dimensions are, by nature, internally inflicted; while the fourth one is naturally from external source. As for technology risk (*TR*); it can originate from either internal or external operational failures. The paper also suggests that in order to mitigate operational risk, an Islamic bank can choose one of the following methods, i) business continuity plan, ii) insurance (takaful), iii) outsourcing, iv) adequate control policy, v) training. The choice of mitigation methods will mainly depend on the originating source of operational risk.

Endnotes

1 It is likened to trade vendors who concurrently practiced business of financing and commercial transactions to other commercial parties.

2 IIFS stands for institutions (other than insurance companies) which offer only Islamic financial services. In many literatures, the term "Islamic banks", "IIFS" or "Islamic financial institutions" are used interchangeably. IFSB opts to use IIFS in its publication.

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Credit Risk Management in Indonesian Islamic Banking

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Abstract

This research aims to analyze credit risk management in the Indonesia Islamic banking industry. Primarily, the credit risk management is related to policies and procedures, credit risk management activities and credit risk controling or mitigating. Research constructed by weighting a number of indicators that reflect credit risk management activities in Islamic banking. The final results of the research are index of credit risk management of the Indonesia Islamic banking industry and indices of credit risk management in the Islamic banking industry. The Index is counted by the method of scoring with the maximum score of 100 and the industrial index is obtained by combining of each Islamic bank through the calculation of weighted average of individual share of financing. Based on the analysis of primary and secondary data, the index of credit risk management of the Islamic banking industry and index aspects of credit risk management, the index of the Indonesia Islamic banking industry come up to a good criterion. Improving the Quality of credit risk management, can be proceded by bank management by improving risk management aspects which have not been adequately assessed. Moreover, improving the quality of credit risk management by the authority of Islamic banking can be pursued by formulating the banking regulations.

Keywords: *Credit risk, Risk mitigation, Risk controlling, Islamic banking, Indonesia*

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Background

The global Islamic finance has shown progressive development in the last two decades. Particularly, it grows between 15% - 20% and is operated in more than 75 countries with at least 300 Islamic financial institutions institutions (Shtayyeh and Piot, 2008). Indonesia as a country with the most populated Moslem people has a potential to be one of the leading countries in this field. In fact, the last 5 years showed a tremendous growth of the Islamic banking industry which is 40% per year eventhough it still has 4.55% market share. Further, it has a unique characteristic of intensive financing to the Small and Micro Entrepresis (SMEs) with a high Financing to Deposit Ratio (FDR).

However, such financing is not properly supported by supply of human resources, intensive monitoring and advanced information technology. As such, the Indonesian Islamic banking industry somehow faces high credit risk. Especially, Sharia prohibits changing the ongoing price in trade based transactions, charging any pinalty in default case(s) and, claiming non Islamic return as the bank's profit. These prohibitions create difficulty for Islamic banks to apply conventional based credit risk mitigation techniques and invite moral hazard in the debtors to misconduct or miuse the financing.

The other potensial factor of credit risk is in the application of *mudarabah* and *musharakah* contracts with profit and loss *sharing* (PLS) concept in bank's financing. Particularly, such contracts may trigger debtors to take exessive risks in doing business becuase the loss becomes responsibility of the Islamic banks. Meanwhile, on the liability side, Islamic banks may not transfer the business loss(es) to depositors as the true owner of the funds. This could create non prudential financing and increase credit default(s).

The paper attempts to measure and value the credit risk management application in Islamic banks. In particular, it would value some credit risk management indicators in order to have a credit risk management index as an indicator to check the credibility and soundess of the Islamic banking industry in managing depositors' funds and mitigating credit risk.

Literature Reviews

Credit risk management consists of procedures and policies of credit risk mitigation, identification of risk, measurement of risk and, monitoring and controlling risks (Bank Indonesia, 2011a; Rivai and Arvyan, 2010). It indeed determines the quality of credit management because bad credit risk management may downgrade bank financing and *vice versa* (Abadi *et al.*, 2011). Khan and Ahmed (2008) and Islamic Financial Services Board (2009) explains that credit risk management in Islamic banks requires the involvement of four things namely: (i) the roles of the board of directors, (ii) the roles of senior management, (iii) the availability of infrastructures such as administration system, information and monitoring system and, (iv) the availability of an independent credit reporting.

Meanwhile, Greuning and Iqbal (2008) address three policies in the management of credit in Islamic banks. First of all are policies to limit and decrease credit risk inclusing policies to concentrate bank financing, reducing credit exposure in core debtors and relocating financing to certain economic sectors, spreading the bank financing. Secondly is policy with regard to asset classification which includes regular evaluation on the quality of financing portfolio and limitation of the time of *review*. Thirdly is policy to have some reserves for business loss prevention. Moreover, they stress on the importance of evaluation on existing policis and practices of credit risk management in Islamic banking.

From conventional literatures, Dam (2010), Richard *et al* (2009), Anthony (1997) and Bank for International Settlements (2000), the Basel Committe on Banking Supervision (BCBS) in the documents of the Principles for the management of credit risk (2000) suggests five principles in valuing credit risk management in banks. First, creating conducive environment for credit risk management including the roles of the Board of Director (BoD) and Senior Management in managing credit risk. Second, credit extenstions are conducted based on prudential credit expansion. Third, the administration process, measurement and credit supervisory should be robust. Forth is a proper credit management. Firfth is the roles of supervisor in determining supervisory independence in valuing strategies and credit extension policies, limit of the credit, and effectiveness of the risk management.

In order to analyze, value and get the credit risk management index of the Indonesian banking industry, and based on Bank Indonesia regulation on quality of assets (Bank Indonesia, 2011b) and banking supervision based on risk (Bank Indonesia, 2009), this research uses scoring method to compute the index and classifies the credit risk management activities in three aspects namely: (i) policies and procedures of credit risk management, (ii) management of credit risk and, (iii) credit risk mitigation. Scoring is applied to these three aspects of credit risk management with the maximum total index of 100. In particular, the total index of credit risk management (Cr) is the accumulation of the: index of policies and procedures of credit risk management (X), index of management of credit risk (Y) and, index of credit risk mitigation (Z). Mathematically, credit risk management (Cr) is simply written as:

$$Cr = \sum_{t=1}^{n} X + \sum_{t=1}^{n} Y + \sum_{t=1}^{n} Z \tag{1}$$

$$Cr = \sum_{t=1}^{n} X + \sum_{t=1}^{n} Y + \sum_{t=1}^{n} Z \tag{2}$$

$$\sum_{t=1}^{n} Y = \sum_{t=1}^{n} D + \sum_{t=1}^{n} E + \sum_{t=1}^{n} F + \sum_{t=1}^{n} G \tag{3}$$

$$\sum_{t=1}^{n} Z = \sum_{t=1}^{n} H + \sum_{t=1}^{n} I \tag{4}$$

A stands for credit risk policies and strategies of the Board of Directors. *B* is the activity of the senior managers in implementing credit risk policies and strategies of the Board of Directors. *C* is the communication of the policies and risk management strategies to all parties in the Islamic bank. *D* is the activity of the Islamic banks to apply the standard operating procedures and central bank regulation on credit risk management. *E* is the compliance of the Islamic financing with the prudential financing activities.

F is the administration process, financing measurement and supervisory and, credit risk identification from the bank's product and activities (internal sources of credit risk). *G* is the method and information system used by Islamic bank to value, measure and monitor the credit risk. *H* is the bank effort to comply the financing activites with the standard operating procedures and the banking produntial regulations (corrective actions). *I* is bank activity to periodically evaluate the policies and strategies in managing credit risk. Finally, *n* is the number of respondents. After valuing every aspect of the credit risk management, four criteria are determined to decide the quality of credit risk management which are: (1) Excellent, (2) Good, (3) Satisfactory and (4) Poor. Table 1 depicts the values of the index of the credit risk management.

Table 1. Values of the Index of the Credit Risk Management

Aspect	Total Values	Criterias of the Index Values			
		Excellent	Good	Satisfactory	Poor
Policies and Procedures (X)	40	40 ≥ X > 32	32 ≥ X >24	24 ≥ X > 16	X ≤ 16
Management of Credit Risk (Y)	30	30 ≥ Y > 24	24 ≥ Y > 18	18 ≥ Y > 12	Y ≤ 12
Mitigation of Credit Risk (Z)	30	30 ≥ Z > 24	24 ≥ Z > 18	18 ≥ Z > 12	Z ≤ 12
Total Management of Credit Risk (Cr)	100	100 ≥ Cr > 80	80 ≥ Cr > 60	60 ≥ Cr > 40	Cr ≤ 40

Technically, in counting the index of credit risk management (*Cr*) or in every aspect of credit risk management above (*X*, *Y* and *Z*), the lowest index value is limited to 40% followed by the interval of 20%. The lowest index value of 40% is decided as the minimum effort of Islamic bank to conduct a robust credit risk management. Further, it considers that the policies and procedures of credit risk management (*X*) is the most important aspect than the other two aspects in the management of credit risk. As such, it is given 40 points while the aspect of the management of credit risk (*Y*) is given 30 points and the same as credit risk mitigation (Z). The detail of the points is described in Table 1 above.

Data and Assumptions

The object of the research is the Islamic commercial banks (BUS) in Indonesia as they both capture more than 80% of the total Islamic banking industry and have independent credit risk management policies. The Islamic banking units (UUS), which are units in the conventional banks, do not belong to the object of the paper because their risk management depends on the holding companies (conventional banks).

Primary data is collected with questionnaires to the respondents from Islamic banks. Particularly, the paper targets researchers in every Islamic bank and searches for related information from related institutions such as Bank Indonesia. Researchers in Islamic banks are those from managers/decision makers in Islamic banks, bank supervisors from Bank Indonesia, or persons in charge of credit risk management in Islamic banks. Meanwhile, the secondary data was taken from Bank Indonesia data based from December 2000 – April 2012. Particularly, it takes monthly data of Islamic bank financing and *non performing financing* (NPF).

Assessment on Credit Risk Management

Principally, index of credit risk management is constructed based on weighted average of the individual Islamic bank index of credit risk management. Whilst, the weight of an Islamic bank is from its share of financing in the Islamic banking industry. Similarly, index of every aspect of credit risk management of the Islamic banking industry is gained from a weighted average of every aspect of credit risk management of an individual Islamic bank. A composition or share of financing of an Islamic bank can be seen in the Table 2 below.

Table 2: Share of Financing of an Islamic Bank per Total Financing

No	Banks	Financing	
		Nominal (Million Rp)	Share of Financing
1	Bank Syariah Mandiri	37,146,234	42.69%
2	Bank Muamalat Indonesia	23,657,134	27.19%
3	Bank BRI Syariah	9,237,874	10.62%
4	Bank BNI Syariah	5,576,990	6.41%
5	Bank Syariah Mega Indonesia	4,390,667	5.05%
6	Bank Syariah Bukopin	2,088,447	2.40%
7	Bank Jabar dan Banten Syariah	1,860,554	2.14%
8	Maybank Syariah	1,234,361	1.42%
9	Bank BCA syariah	673,238	0.77%
10	Bank Panin Syariah	786,357	0.90%
11	Bank Victoria Syariah	62,691	0.42%
	Total	**87,014,547**	**100%**

Source: Bank Indonesia (up to April 2012)

Valuing aspects of credit risk management

Aspect of Policies and Procedures

The output of the survey with regard to aspect of policies and procedures comes up with the index values of 30.56. Based on table 1, such index values constitute to a good criteria meaning that in general the quality of Islamic banking policies and procedures to manage credit risk is relatively good. Particularly, the survey finds that:

(i) Application of policies and procedures of credit risk management as well as transfer of responsibility to the lower level have captured all aspects of credit risk mitigation. Moreover, such policies, procedures and limit of responsiblity have even been stated in the standard operating procedures (SOP) of each Islamic bank and have been well-understood by all related parties in the bank.
(ii) The transfer of responsibility to manage credit risk, limit of it, internal rating and the quality of assets in the SOP is fully implemented and reviewed periodically. In addition, review of the SOP has been done properly capturing materials, frequency and report to the board of commissioners and board of directors. In addition, Islamic banks have conducted stress testing test based on their complexity and capacity.
(iii) Communication of policies and strategies of credit risk to all employee have been done completely through various medias. As such, human resources are valued good enough based on quantity and quality to manage credit risk.

The results of measuring aspect of policy and credit risk management procedures are delivered in Tabel 2 below.

Table 2: Measuring Policy and Credit Risk Management

BANKS	Policy and Credit Risk Management Procedures			
		Policies & Strategies	Implementation of Policy and Strategies	Communication of Policies and Strategies
	X	A	B	C
AA	28,4	14,2	12,5	1,7
BB	22,5	10,7	10,7	1,0
CC	30,6	15,7	12,5	2,3
DD	30,4	15,7	11,7	3,0
EE	21,0	12,7	6,1	2,2
FF	24,5	13,5	8,4	2,5
GG.	26,6	14,5	9,8	2,3
HH	25,9	13,3	10,0	2,5
JJ	32,7	17,0	13,7	2,0
KK	29,6	16,3	11,9	1,4
LL	23,0	11,2	9,1	2,6
Industry Index	30,56			

Table 2 identifies 3 (three) Islamic banks (BUS) with a 'satisfactory' criteria of the index of policy and credit risk management. Particularly, their index values are 21, 22.5, and 23. One BUS has an 'excellent' criteria with the index value of 32.7 and 7 (seven) BUS have only a 'good' criteria. Some BUS have low index because:

(i) They do not have a comprehensive credit risk management policy, limited communication process and non routine evaluation of the SOP.
(ii) They have not applied internal rating to depositors and stress testing to check the adequcy of capital and liquidity. Moreover, there is no comprehensive and clear authority to extend financing in their middle management and it does not include types of industry, economic sectors, geography, and maturity profile.
(iii) Communication of policies and credit risk management are under responsibility of a certain team or individual dealing directly with controlling of credit risk. In fact, those should be delivered to all employees and to internalize such policies and management in the organization. Meanwhile, evaluation of both policies and credit risk management procedures is conducted when (a) the banks need to do it, (b) problems are found in extending financing or, (c) banking regulations are changed. Moreover, there is no routine evaluation and Islamic banks are only reactive (not proactive) to any change in credit risk.

Aspect of credit risk management

Output of the survey gives an index value of the credit risk management in Islamic banks of 22.94 and based on the credit risk management measuring system, it complies with a good criteria. It means that the credit risk management in the Indonesian Islamic banking industry is relatively good with some minor corrections, particularly:

(i) Indentification, measurement and monitoring of credit risk in the Indonesian Islamic banking industry are well-managed both the materials and the frequency.
(ii) A consistent/continuous internal rating and stress testing test are practiced refering to the complexity and capacity of each Islamic bank. Further, the structure of organization in the Indonesian Islamic banking industry supports the financing activities.

(iii) Financing activities have been organized properly based on a robust financing procedures which starts from analysis of financing proposal, credit mitigation adequacy, approval process, financing administration and disbursement of financing.
(iv) Valuation of the financing quality is continuously organized by considering collectibility, payment capacity, liquidity, cash flow estimation and macroeconomic condition.
(v) Information system can provide data for analysis, management, controlling and credit risk management policy formulation. A continuous review of the information system including the materials, frequency and reporting to both board of commisioners and directors.

The outputs of the credit risk management is depicted in Tabel 3 below:

Table 3: Measuring Management of Credit Risk

BANKS	Management of Credit Risk (Y)				
		Implementation SOP and Regulation	Extending Financing with Standard Procedures	Administration, Measurement and Supervision of financing	Method and Information System
	Y	D	E	F	G
AA	22,4	5,9	5,1	6,3	5,2
BB	22,9	5,9	5,0	6,7	5,3
CC	20,5	5,4	4,5	6,2	4,4
DD	23,1	7,1	4,8	6,5	4,8
EE	14,3	4,5	2,6	5,8	1,5
FF	16,3	2,8	4,6	6,0	2,9
GG	21,8	6,1	5,1	6,8	3,7
HH	22,9	6,6	4,7	6,5	5,2
JJ	25,4	6,4	5,4	7,4	6,3
KK	23,2	6,0	6,0	6,7	4,6
LL	17,9	4,8	4,5	6,0	2,7
Industry Index	22,94				

Tabel 3 identifies 3 (three) Islamic banks (BUS), which have credit risk management index of Satisfactory, with the values of 14.3, 16.3 and 17.9. In addition, 1 (one) BUS stands on an excellent index criteria with a value of 25.4 and the other 7 (seven) BUS fall in a good criteria because:

(i) Identification and credit risk assessment are not appropriate, not regularly assessed and based on demand. These have caused inaccurate credit risk measurement.
(ii) They have not distinguised administration function and banking operations in the organization structure. In particular, administration function of financing activities is still managed by the operational unit as such it may not independently function as a back office control unit in financing disbursement.
(iii) Review of the information system is not regularly arranged and depends on banking regulatory change or request by the banking regulator. Lastly, the quality of the asset is still manually assessed with the possibility of human error and credit engineering.

Aspect of credit risk controlling

The index of the industry credit risk controlling is valued 23.92 or falls in a good criterion. It shows a modest control of credit risk in the Indonesian Islamic banking industry with some constraints to be sorted out. Such value comes from certain findings, which are:

(i) Anticipative and corrective actions in the case of low asset quality performance are conducted by Islamic banks perfectly. Specifically, they anticipate credit losses by intensifying financing collectibility, monitoring business conditions, managing cash flow, and collateral.
(ii) A more prudent and tighter asset classification stipulated by Islamic banks than the central bank to maintain the robust financing besides sanctions on the violation of credit risk management procedures.
(iii) The same as before, Islamic banks have evaluated the policies and procedures of the credit risk management properly including reporting to the board of directors and commisionners.

The outputs of the credit risk controlling can be seen in table 4 in the following:

Table 4: Measuring Controlling of Credit Risk

BANKS	Controlling Credit Risk		
		Corrective Action	Policy Evaluation and Strategies
	Z	H	I
AA	21,3	14,8	6,6
BB	20,8	13,6	7,2
CC	22,7	14,5	8,2
DD	22,9	14,9	8,0
EE	16,9	12,4	4,5
FF	23,0	15,4	7,6
GG	21,3	14,5	6,9
HH	23,9	15,6	8,3
JJ	25,9	17,5	8,4
KK	25,4	15,0	10,4
LL	21,6	14,8	6,8
Industry Index	23,92		

Unlike the previous result, table 4 finds 2 (two) BUS, which have credit risk controlling index of excellent (above the industry) with the values of 25.9 and 25.4. Meanwhile, 1 (one) BUS is classified as satisfactory with the value of credit risk controlling index of 16.9. The other 7 (seven) BUS olny have a good credit risk controlling index because:

(i) Reserve policy for every financing is relied on collectibilities per se and does not consider business condition, cash flow of enterpreneurs and macroeconomic condition.
(ii) Evaluation of the policy and credit risk management procedures is not a routine agenda, rather it depends on the demand for evaluation or if it is needed by the boards.

In fact, credit risk controlling is more dominant than credit risk management with an index of good (23.92). This is reasonable because credit risk controlling may avoid Islamic banks from both low asset quality and business losses. Moreover, credit risk controlling is much easier to do than mitigating credit risk because Islamic banks have prepared some policies and actions to controll credit risk.

Index of credit risk management of the indonesian Islamic Banking industry

The overall credit risk management of the Indonesian Islamic banking is counted 77.41 as seen table 5, and classified as a good criterion. Such an index comes out because of some facts, which are:

(i) Policies, procedures, limit of credit risk and transfer of responsibility to manage credit risk have captured all areas of credit risk management and have been stipulated in the Islamic banks standard operating procedure (SOP). Moreover, policies and strategies of credit risk management have been well-communicated with all employees via various media.

(ii) Most of the credit risk controlling in the Indonesian Islamic banks follow the process of identification, measurement, and monitoring based on the SOP. Moreover, internal rating and stress testing are consistently done with standard materials and high frequency. Further, prudential financing activities start from financing analysis, risk mitigation adequacy, financing contract agreement, financing administration and financing disburshement.

(iii) Quality of asset is valued referring to financing collectibility, payment capacity, liquidity capacity, estimated cash flow and macroeconomic condition. Moreover, information system can provide required data for financing analysis, management, controlling and timely basis credit risk management policies.

(iv) Credit risk controlling is conducted with a liquidity reserve to mitigate any loss by considering financing collectibility, business condition, cash flow, collateral and macroeconomic condition. Moreover, sanction is imposed in any violation of the implementation of credit risk management policies.

(v) Evaluation of the credit risk management policies and procedures is organized properly capturing aspects of evaluation, frequency (regularly and suddenly) and report to the board of directors and commissioners.

Table 5: Overall Credit Risk Management

BANKS	Policy and Procedures	Controlling of Credit Risk	Management of Credit Risk	Index of Credit Risk Management
	X	Y	Z	
AA	28,4	22,4	21,3	72,1
BB	22,5	22,9	20,8	66,1
CC	30,6	20,5	22,7	73,7
DD	30,4	23,1	22,9	76,4
EE	21,0	14,3	16,9	52,2
FF	24,5	16,3	23,0	63,7
GG	26,6	21,8	21,3	69,7
HH	25,9	22,9	23,9	72,6
JJ	32,7	25,4	25,9	84,0
KK.	29,6	23,2	25,4	78,3
LL	23,0	17,9	21,6	62,5
Industry Index	30,56	22,94	23,92	77,41

However, there is one Islamic bank (BUS) namely Bank EE which has a criteria of satisfactory of the credit risk management and another one has a criteria of excellent. The other 9 (nine) BUS are considered having a criteria of good. Particularly, a low index of credit risk management of Bank EE is also revealed in its three aspects of credit risk management which fall in satisfactory criteria as shown in table 5. As such, the management of Bank EE need to have corrective actions to improve its credit risk management, including banking regulator (central bank of Indonesia) to supervise and guide such improvement efforts. Failure in improving credit risk management in Bank EE may potentiall effect other Islamic banks in the industry as well.

Conclusion and Recommendations

Credit risk management policies and procedures in the Indonesian Islamic banking industry has been quite good with the index value of the credit risk management of 30.56. Nonetheless, there are still some minor limitations which could be solved by the banks and banking regulators.

Individually, there are some Islamic banks which have an index criteria of satisfactory and these banks should be awared by the banking regulator as well. Some improvements can be done such as stipulating a central bank standard credit risk management policies and procedures and treating credit risk management as a priority activity in every Islamic bank. The paper further recommends some policies which are:

(i) Islamic banks having a good criteria of credit risk management index (either overall of per aspect of credit risk management) should: (a) highly impose credit risk management policies and procedures, (b) apply an intensive credit risk controlling and (c) mitigate any credit risk.

(ii) The central bank needs to require every Islamic bank to apply internal rating and stress testing test to investigate any potential of credit risk. On the other hand, Islamic banks are demanded to improve their communication mechanism in disseminating policies and procedures of credit risk management to all employees.

(iii) Finally, the evaluation of credit risk management policies and procedures needs to be regulated formally by the central bank in order to anticipate any credit risk.

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Measuring the Perceived Service Quality and Customer Satisfaction in Islamic Bank Windows in Libya Based on Structural Equation Modelling (SEM)

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Abstract

The growth of the banking sector is vital for a country's economic development as it provides most of the financing sources for businesses. Customer satisfaction is one of the most important factors in determining the feasibility of a banking operation. Thus, this study aims to measure customer satisfaction in Libyan commercial banks, using the structural equation model (SEM). This study uses the dimensions from the modified SERVQUAL model, namely Tangibility, Assurance, Reliability, Responsiveness and Empathy for 366 cross-sectional samples that were taken from three commercial banks in Libya, namely Gumhouria Bank, Wahda Bank and Sahara Bank in year 2012. The study found that responsiveness was the strongest indicator of customer satisfaction using the dimensions of perceived quality, followed by reliability, empathy and assurance. The results of this study will be useful for policy-making by Libyan authorities responsible for the development of the banking sector.

Keywords: *Customer Satisfaction, Perceived Service Quality, Structural Equation modeling (SEM)*

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Introduction

Customers are the lifeblood of any organisation, because customer satisfaction is the key to the continued survival of an organisation. Service quality is the key to measuring user satisfaction. Satisfaction is particularly important in relation to organisations that deliver services, rather than goods (Nicholls *et al.*, 1998). The onset of competition from private players and foreign banks and the initiation of banking reforms since the early (1990s?) have led to an increased emphasis on the efficiency of customer service. Moreover, in the tough competitive arena in which these banks operate today, maintaining the quality of service is a pre–requisite for survival. Therefore, the measurement of service quality has increasingly created an interest among service providers (banks) and scholars (Sharma and Mehta, 2005). Hence, measuring the customer satisfaction and the quality of services provided to customers by banks is one of the topics that carry high importance in the field of management area, particularly in dealing with business organisations that value quality services.

While Islamic banks are considered to attract individual customers mainly due to their religious orientation, with the increasing number of Islamic banks and Islamic windows, other factors such as quality may play a role in determining customer patronage and satisfaction. For this reason, there is a growing volume of literature available in the case of Islamic banks as well (see: Abdullah and Kassim, 2009; Abdullrahim, 2010; Almossawi, 2001; Al-Tamimim *et al.*, 2003; Amin and Isa, 2008; Erol and El-Bdour, 1989; Gait and Worthington, 2008; Metawa and Almossawi, 1998; Al Zaabi, 2006; Othman and Owen, 2002a; Othman and Owen, 2002b).

As for the case study on Libya, as it was known until the revolution, Libya had not had any significant presence of Islamic banking and finance. The Central Bank of Libya started initiatives to develop Islamic banking practices in Libya with the publication of its guideline numbered A. R. N. M. No. (9) in 2009 that granted approval for commercial banks to start in the development and delivery of Islamic- banking products. Many commercial banks such as the Jamahiriya Bank as the biggest bank in Libya, the Wahda Bank, the North African Bank and Sahara Bank, established their Islamic-banking facilities. To guide the operations of the banks issuing Islamic banking products, the Central Bank of Libya issued the publication of. A. R. N. M. No. (9/2010) that explained the controls and foundations of Islamic banking operations in 2010. After the revolution, the new political elite decided to islamise the financial system. Thus, at the end of 2012, the General National Congress of Libya passed a law to stop the citizens of Libya from dealing with *riba* immediately. The government, however, is planning to abolish *riba* transactions between institutions and the banks starting in 2014. With these developments, this study, thus, aims to measure customer satisfaction through perceived service quality in Libyan Islamic windows. While it is true that Libya has recently opened its doors for Islamic finance, there are a growing number of institutions converting their operations to Islamic banking, which require studies on customer satisfaction for further service improvements.

Literature Review

The concept of customer satisfaction has been defined in various ways. Zeithaml *et al.*, (1993) suggested that customer satisfaction is a function of the customer's assessment of service quality, product quality and price. Meanwhile Rust and Oliver (1994) define customer satisfaction as a summary cognitive and affective reaction to a service mishap that results from the comparison of customers' perceptions of service quality with their expectations of service performance. In recent years, customer satisfaction has gained new attention within the context of the quantum leap from transaction marketing to relationship marketing (Martin, Adrian and David, 2002). Relationship marketing refers to all marketing activities directed toward establishing, developing, and maintaining successful relational exchanges (Yi and La, 2004). According to Kotler and Armstrong (2006), customer satisfaction depends on the service's perceived performance relative to the buyer's expectations. If the service's performance falls short of expectation, the customer is dissatisfied. If performance matches expectations, the customer will be satisfied. If performance exceeds expectations, the customer is highly satisfied. Consequently, highly satisfied customers make repeat purchases and tell others about their good experiences with the service. Smart banks aim to delight customers by promising only what they can deliver, then delivering more than they promise. For example, a dissatisfied customer will tell seven to 20 people about their negative experience while a satisfied customer will only tell three to five people about their positive experience. Therefore, in this study, we will use customers to evaluate service quality by considering several important quality attributes in Libyan commercial banks, and we will suggest to bank managers some improvements on certain attributes that show a low satisfaction level.

Service quality has been shown as an elusive and abstract construct that is difficult to define and measure (Parasuraman *et al.*, 1988; Brown and Swartz, 1989; Carman, 1990). This is because it is difficult to evaluate service performance due to its unique features: intangibility, heterogeneity, inseparability and perishability (Parasuraman *et al.*, 1985). On the other hand, service quality is an important tool in the organisation's struggle to differentiate itself from its competitors (Ladhari, 2008). Due to this fact, the relevance of service quality to institutions is emphasised especially in the way that it offers a competitive advantage to institutions that strive to improve it and hence bring customer satisfaction.

The measurement of service quality was developed by many researchers who all provided different definitions. The most well-known and cited model is the model of Parasuraman *et al.* (1985). They identified ten determinants of service quality through focus group studies; reliability, communication, access, tangibles or tangibility, responsiveness, competence, courtesy, credibility, security, and understanding and knowledge of the customer. Later these ten dimensions were further codified into five dimensions: tangibles, responsiveness, reliability, assurance and empathy in measuring service quality, known as SERVQUAL (Parasuraman *et al.*, 1988). The reliability dimension refers to the ability to perform the service dependably and accurately. The responsiveness dimension refers to the willingness to help customers and provide prompt service. The tangibles dimension refers to the physical facilities, equipment, and appearance of personnel. On the other hand, assurance dimension refers to the employee's knowledge, courtesy and ability to convey trust and confidence. In addition, empathy dimension refers to the level of caring and individual attention provided to the customer. It is vital to measure customers' perceptions regarding service quality in order to improve the customers' satisfaction in the future.

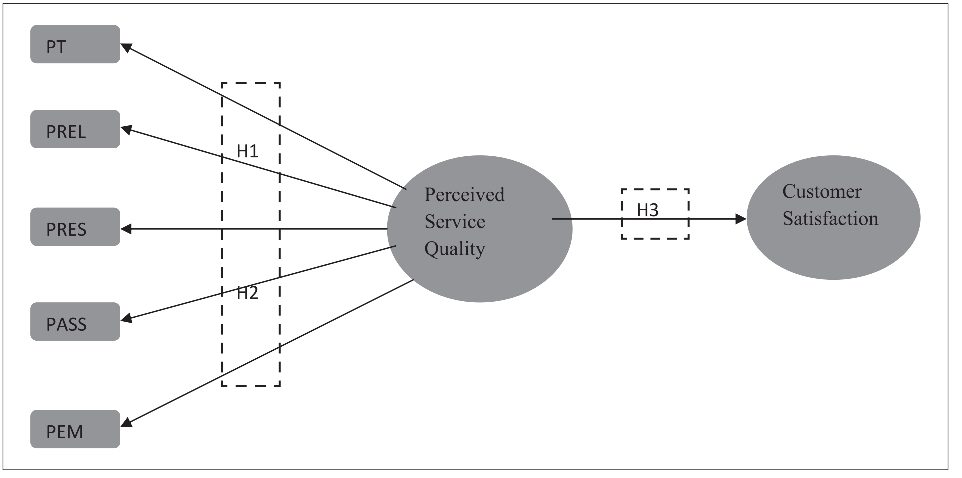
Many studies have been conducted which have examined the effects of service quality on customer satisfaction, but relatively few studies examined the perceived service quality with the satisfaction formation model. One of the most widely used instruments for assessing customer satisfaction is SERVQUAL developed by Parasuraman *et al.* (1988). Researchers have found a close relationship between service quality and customer satisfaction (Parasuraman *et al.*, 1985; 1988 and Bitner *et al.*, 1990). Anderson *et al.*, (1994) suggested that improved service quality will provide a significant impact on customer satisfaction. In addition, Angur *et al.*, (1999) suggested that the SERVQUAL scale is multidimensional and is able to provide more diagnostic information due to its greater variability across banks than the SERVPERF scale.

SERVQUAL dimensions were applied in many studies on customer service in Islamic banks in many environments where Islamic banking is practiced. Amin and Isa (2008) examined the relationship service quality perception and customers' satisfaction in Islamic banks in Malaysia using the SEM approach by studying the six dimensions of SERVQUAL measurements. They found that the relationship between service quality and customer satisfaction was significant, with the majority of Islamic banking customers satisfied with the overall service quality of the full-fledged and dual-banking systems. In the Middle East, studies on customer service were conducted by researchers such as Metawa and Al-Mossawi (1998), Othman and Owen (2002) and Al-Zaabi (2006) using the established SERVQUAL criteria. Other studies conducted on customer satisfaction in the case of Islamic banks such as those by Abdullah and Kassim (2009), Abdullrahim (2010), Al-Tamimim *et al.*, (2003), Gait and Worthington (2008), Othman and Owen (2002a) and Othman and Owen (2002b). The methods adopted in these studies include factor analysis identification of customer service dimensions, examination of the relationship between service quality perception and customer service satisfaction as well as an examination of the factors influencing customer satisfaction taking the SERVQUAL dimensions as independent variables in the cases of various Muslim countries.

Theoretical Framework and Methods

We developed a theoretical framework on the basis of evidence available in the above-mentioned literature. The dependent variable is customer satisfaction and the independent variable is service quality, according to which the components of tangibility, reliability, responsiveness, assurance and empathy are tested, as expressed in Figure 1.

Figure 1: The Research Framework



To test the relationship between customer satisfaction and service quality variables, the following hypotheses have been developed:

H1: There is a significant positive relationship between the sub-dimensions of perceived quality (PT, PREL, PRES, PASS and PEM) and the perceived quality- primary dimension.

H2: Customers vary in their perceptions of the importance of each of the sub-dimensions of perceived service quality.

H3: There is a significant positive relationship between perceived service quality and customer satisfaction.

Data Collection Method:

For this study, data was collected via a questionnaire, which consisted of three major sections. The first section contains five items, which are used to measure customer satisfaction, while the second section consists of the dimensions of the perceived quality as proposed by Parasuraman *et al.*, (1988). The third section contains questions on the general information of the respondents including: gender, age, qualifications, occupations, monthly income, marital status and the name of the bank. We studied 22 items for perceived quality on the five- point Likert scale of the range of attitude, from 1-strongly disagree to 5-strongly agree.

Sampling

A total of 600 questionnaires were distributed of which only 366 questionnaires were useable for analysis (61% response rate). Specifically, questionnaires were distributed to every customer who came to the bank during the business hours (8.00-14.00) from Sunday to Thursday and Saturday morning (8.00-12.00). The study sample is decided to be any customer who has bank dealings in the form of owning a bank account, obtaining finance, or conducting money transfers between banks. The questionnaires were distributed in two ways. Firstly, the questionnaires were given to bank employees who were requested to distribute the questionnaires to their customers. Secondly, we met with potential respondents personally and distributed the questionnaires to customers outside the bank branches with help from friends in other cities. The questionnaire was translated into Arabic language to ensure clarity, owing to the fact that all respondents in this research are Libyans whose national language is Arabic.

Data Analysis

The statistical techniques employed in this study are as follows: descriptive and frequency analyses were conducted to represent the respondents' demographic variables. In addition, a reliability test to check for the "internal consistency" of the questionnaire by applying Cronbach's Alpha test. Normality distribution was tested for by checking for skewness and kurtosis through the application of structural equation modelling (SEM). The researcher then performed the confirmatory factor analysis to test the measurement model specifying the posited relations of the observed variables to the underlying construct. Both first-order confirmatory factor analysis models and the second-order confirmatory factor analysis model for perceived service quality were run. The second-order confirmatory analysis was designed to test the relationships between five sub-dimensions (tangibility, reliability, responsiveness, assurance and empathy) and one primary dimension of perceived service quality. Finally, the researcher performed structural equation modeling (SEM) to determine the relationship between customers' satisfaction and the underlying construct of perceived service quality as indicated by the SERVQUAL model.

Results and Discussion

Respondents' Demographic Profile:

Table 1 shows that the majority of respondents' characteristics are males (61.2%), aged between 26 to 40 years old (44.8%), with a high diploma or bachelor degree (45.6%) academic qualifications. The majority of the respondents are government employees (60.4%) with 63.7% of respondents having an income of more than 801 L.D .58.7% of respondents are married.

Table 1: Respondents' Demographic Profile

No	Respondent Characteristics		Frequency	Percentage
1	Gender	Male	224	61.2
		Female	142	38.8
2	Age	Below 25 years	61	16.7
		26 to 40 years	164	44.8
		41 to 55 years	95	26
		Above 56 years	46	12.6
3	Qualifications	No academic qualification	41	11.2
		Secondary School	84	23
		High Diploma or Bachelor	167	45.6
		Master	60	16.4
		PhD	14	3.8
4	Occupations	Government Employees	221	60.4
		Private Sector Employees	85	23.2
		Working Endependently	49	13.4
		Student	4	1.1
		Not working	7	1.9
5	Monthly income	Less than 350 L.D	5	1.4
		351 to 500 L.D	29	7.9
		501 to 800 L.D	99	27
		Above 801 L.D	233	63.7
6	Marital status	Single	125	34.2
		Married	215	58.7
		Widowed / divorced	26	7.1
7	Name of the bank	Gumhouria Bank	137	37.4
		Wahda Bank	119	32.5
		Sahara Bank	110	30.1

Normality Test

The results related to the normality test for the sample indicated that the absolute values of skewness and kurtosis were (-2.52 and 7.26) respectively. These values were less than the respective values of 3 for skewness and 8 for kurtosis as suggested by Kline (2005).

Measurement Model (First and Second Order Confirmatory Factor Analysis)

In order to achieve reliability and validity of the measurement model, first-order and second-order confirmatory factor analysis were conducted for the five-dimensional model of SERVQUAL.

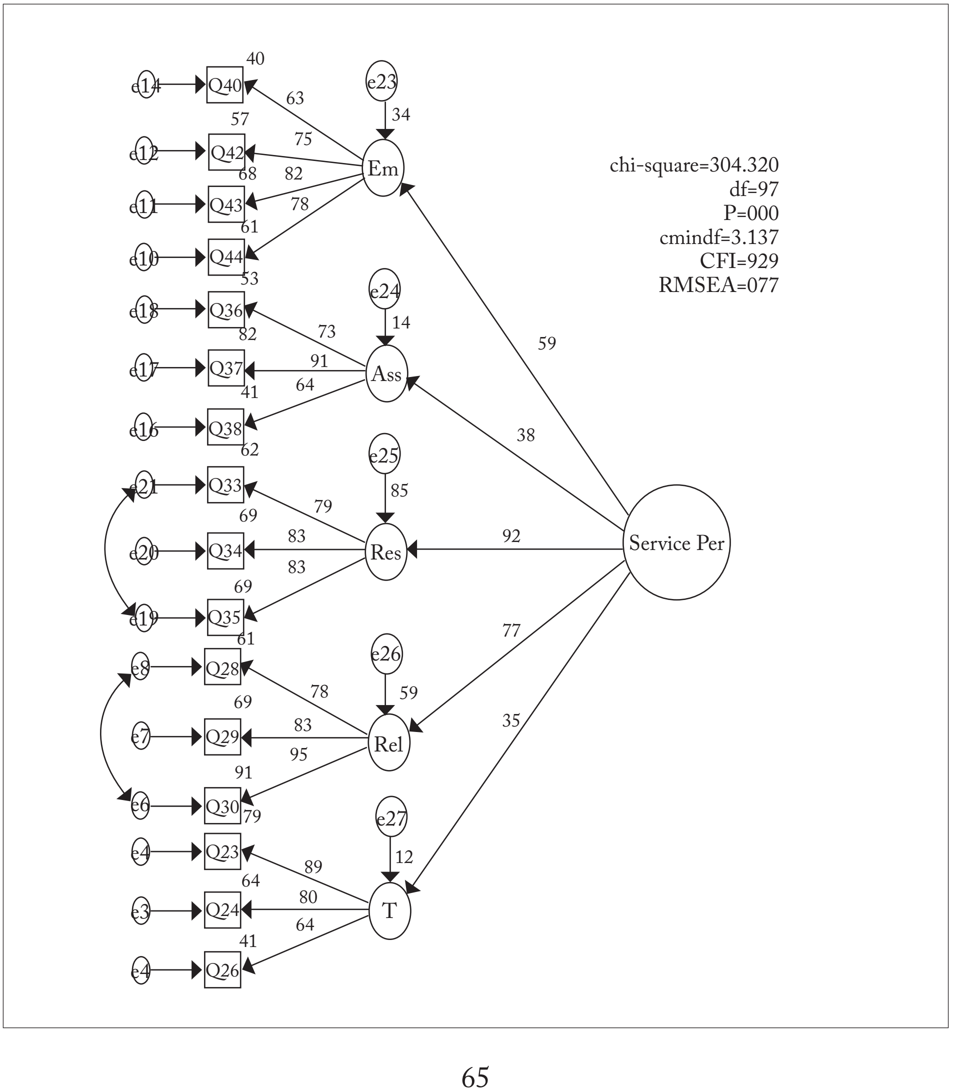
Table 2: Results of the First-order Confirmatory Factor Analysis

Variable Label	Factor loading	Construct reliability	AVE
Tangibility	-	0.808	0.607
P Tan1	0.86(12.258)***		
P Tan2	0.82(12.178)***		
P Tan3	0.64***		
Reliability	-	0.859	0.685
P Rel1	0.89(15.225)***		
P Rel2	0.70***		
P Rel3	0.88(21.175)***		
Responsiveness	-	0.837	0.642
P Res1	0.74(15.291)***		
P Res2	0.86***		
P Res3	0.80(16.825)***		
Assurance	-	0.800	0.583
P Ass1	0.75(11.904)***		
P Ass2	0.86(12.329)***		
P Ass3	0.67***		
Empathy	-	0.829	0.563
P Em1	0.64(11.781)***		
P Em2	0.75(14.154)***		
P Em3	0.82(15.265)***		
P Em4	0.78***		

Figure 2 and Table 2 illustrate the estimated parameters of the five-construct, first-order factor model. As shown, the indicator loadings of items to their respective constructs are weak. After deleting six indicators and recreating the covariance matrices as an entered matrix for the confirmatory factor analysis, the final results of the confirmatory factor analysis for the perceived service quality became stronger. This is reflected by the t-scores ranging from 11.78 to 21.17, indicating that all factor loadings are significant and providing evidence to support the convergent validity of the items measured (Anderson and Gerbing,, 1988). The average variance extracted ranged from 0.563 to 0.685, which were above the recommended threshold of 0.50 as suggested by Fornell and Larcker (1981), indicating that the measures for the five sub-dimensional factors had adequate convergent validity.

Table 2 contains the results of the first-order confirmatory factor analysis. The correlation coefficients of the five sub-dimensional factors ranged from 0.10 to 0.73, which were below the recommended threshold of 0.85 as suggested by Kline (2005), indicating that the measures of the five sub-dimensional factors had discriminant validity. All standardized factor loadings were statistically significant (t-values > 1.96), and ranged from 0.64 to 0.89, which were above the recommended threshold of 0.60 as suggested by Bagozzi and Yi (1988), confirming adequate convergent validity. Figure 2 below provides the graphical illustration of first-order confirmatory analysis.

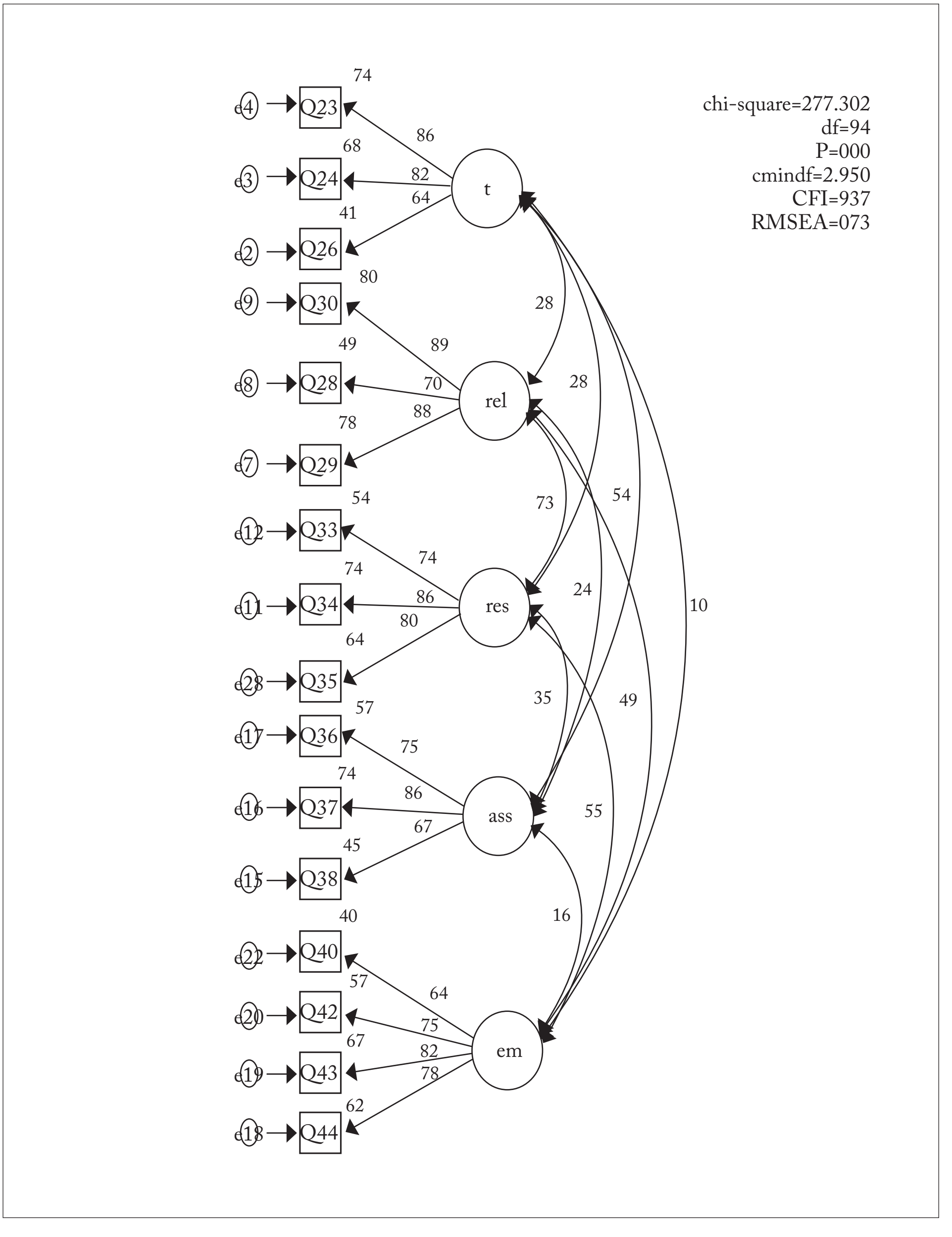
Figure 2: First-order Confirmatory Factor Analysis



Second-order Confirmatory Factor Analysis

The second-order confirmatory factor analysis model for perceived service quality was designed to test the relationships between five sub-dimensions (tangibility, reliability, responsiveness, assurance and empathy) and one primary dimension of perceived service as illustrated in Figure 3.

Figure 3: Second-order Confirmatory Factor Analysis



The standardized solutions of the second-order confirmatory factory analysis model for perceived service quality presented in Table 3.

Table 3: Results of the Second-order Confirmatory Factor Analysis

Variable Label	Factor loading	R
Tangibility	0.35(4.593)***	0.35
Reliability	0.77(8.650)***	0.77
Responsiveness	0.92(8.537)***	0.92
Assurance	0.38(5.044)***	0.38
Empathy	0.59***	0.59
P Tan1	0.89(11.786)***	
P Tan2	0.80(11.919)***	
P Tan3	0.64***	
P Rel1	0.78(15.315)***	
P Rel2	0.83(18.079)***	
P Rel3	0.95***	
P Res1	0.79(14.235)***	
P Res2	0.83(15.808)***	
P Res3	0.57***	
P Ass1	0.73(11.426)***	
P Ass2	0.91(11.091)***	
P Ass3	0.64***	
P Em1	0.63(11.558)***	
P Em2	0.75(13.843)***	
P Em3	0.82(15.689)***	
P Em4	0.78***	

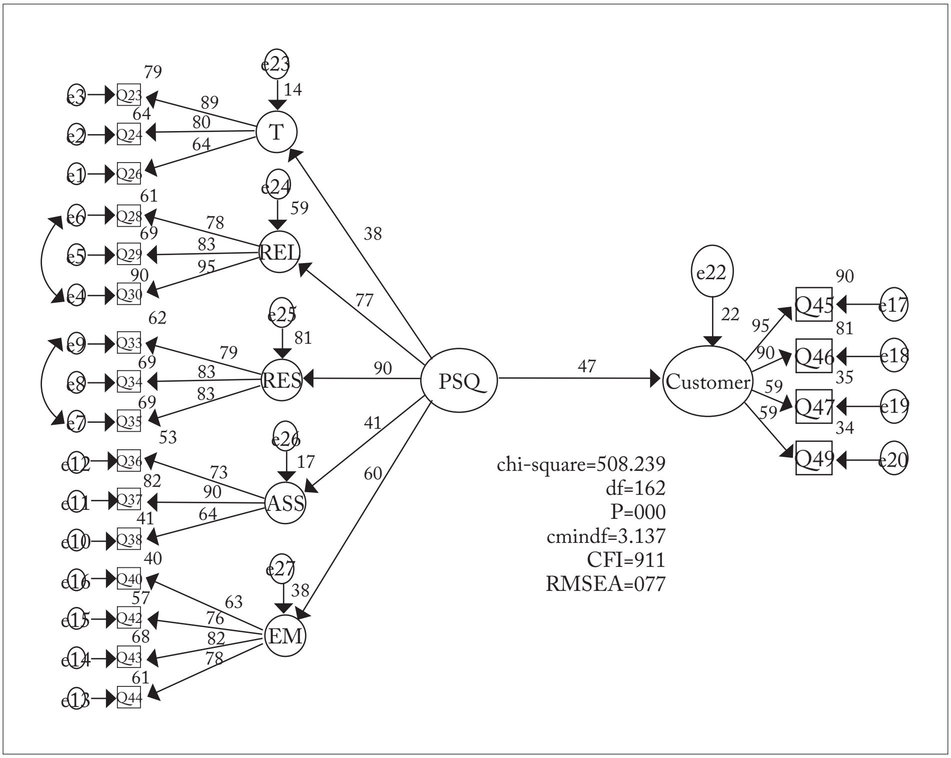
The results proved to be both reasonable and statistically significant. These results supported the reliability and validity of the measures associated with the second-order confirmatory factor analysis model for perceived service quality. Specifically, the factor loading values associated with the five first-order factors indicated that responsiveness (λ = 0.92, t-value = 8.537, $p < 0.000$) was the strongest indicator of the second-order factor (perceived service quality), followed by reliability (λ = 0.77, t-value =8.650 $p < 0.000$), empathy (λ = 0.59, $p < 0.000$), assurance (λ = 0.38, t-value = 5.044 $p < 0.000$), and tangibility (λ = 0.35, t-value = 4.593, $p < 0.000$).

These results supported Hypotheses H1 and H2.

Structural Model and Hypothesis Testing

To test the research hypotheses and investigate the relationships between perceived service quality and customer satisfaction, we conducted covariance structure analysis by using AMOS18. The final structural model of perceived banking service was tested. Figure 4 shows that service quality has positive impact on customer satisfaction (P= 000 while C.R= 4.916 and S.E= 0.419). Therefore, a research hypothesis 3 was supported with strong statistical significance.

Figure 4: Structured Model for Perceived Service Quality



Results in Figure 4 shows that the goodness-of-fit results for the structural equation model indicated a good model fit to the sample data. All model fit indices were sufficiently satisfied with their relative recommended thresholds. The goodness of-fit results of the structural equation model are RMSEA= 0.077, is below the 0.08 cut-off value as recommended in the literature (e.g. Browne and Cudeck, 1993). The CFI=0.911, p=0.000. All other indices showed that the data successfully fit the model with a Chi-square of 508.239 with 162 degrees of freedom, clearly meeting the requirements recommended in the literature (Bagozzi and Yi, 1988; Baumgartner and Homburg, 1996). Model modification was not necessary, as the structural equation model had model fit indices that were more than satisfactory.

Conclusion

The study has revealed that service quality factors will significantly exert an effect on customer satisfaction. We introduced the modified version of the SERVQUAL instrument for service banking from the confirmatory factor analysis. Our study suggested a five-factor model of SERVQUAL including tangibles, reliability, responsiveness, assurance and empathy. Furthermore, we explored the relationships between customer satisfaction and perceived service quality. We also examined the dimensions of the perceived quality of customer service in the commercial banks, and established which one has the highest loading in primary variable (perceived service quality). This study revealed that SERVQUAL is an appropriate instrument for measuring the quality of banking services. The results of this study found the responsiveness variable was the strongest indicator of the second-order factor (perceived service quality), followed by reliability, empathy, assurance and tangibility respectively. We also found that there exists a positive and significant relationship between customers' satisfaction and constructs of perceived service quality represented by the five dimensions. The results of this study will be useful for policy-making by authorities in Libya that are responsible for the development of the banking sector.

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Searching for the Nexus between Money, Deposits, and Loans (Financing) in Malaysian and Turkish Islamic and Conventional Banking: A Comparative Analysis (2007-2013)

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Abstract

This study attempts to analyse the causal relations between bank money and credit channel for Islamic and conventional banking in Malaysia and Turkey on a comparative level. Monthly data for the period from January 2007 to May 2013 is used for the Granger causality analysis. The findings show that in the case of bank money, the causality is from deposits to loans (financing) for Islamic banks in both countries. In addition, although causality is determined from money supply to loans in conventional banking in both countries, the same causality in Islamic banking is only identified in the case of Malaysia. Furthermore, in the causal relationship between bank deposits and money supply, causality is only found from money supply to deposits in both banking types in the case of Turkey. These results suggest that the credit channel may only operate over commercial banking in both countries and that it also only works over Islamic banking in Malaysia.

Keywords: *Islamic banking; bank money; credit channel; causality analysis, Turkey and Malaysia.*

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Introduction

Although there is a consensus on the neutrality of long-run monetary policy in economic theory, the short-run effect of money is not clear. Given that the way the reaction by the real variables of the monetary policy is defined as a monetary transfer mechanism, these channels were first considered as a money channel (or interest rate channel) by Keynesian economic theory; there are, however, now many alternative transfer mechanisms that are complementary to the conventional channel.[1] The differences between all of these alternative transfer mechanisms is demonstrated by the financial structures of the various countries, which make it difficult to offer a uniform definition that is applicable for all countries. Therefore, it appears that the effects of monetary policy to real economy are dependent upon the country and the time period in question. It should, however, be noted that to attain the desired outcomes of the monetary policy in the short and long term, it is necessary to possess a better understanding of how the bank money is generated and how the monetary transfer channels work in an economy. These two elements are important matters that should be considered in the designation of the monetary policies.

In an economy, a sound relationship between deposits and loans is crucial for the effective funding of the real sector. To this end, both conventional interest-based banks and the Islamic banks are important financial intermediaries in fund transfer. Although there are certain differences between the two banking systems in terms of their working principles and impact on the economy, the real function in both systems secures this connection. In conventional banking, money is received from the depositors to offer loans to the investors, yet this requires a different process in Islamic banking because the commercial utilisation of money 'as money' is prohibited in Islam.[2] This prohibition arises since deposits are used in investable businesses and allocated for particular investments for a variable return, which is generated from the relevant investment rather than from a fixed return determined at the time that the deposit is made, as is in the case of conventional finance. Despite these differences, bank money is generated in both banking systems as a result of the connection between deposits and loans, thus implying that establishing a connection between the deposits and loans of the banks as commercial enterprises is inevitable.[3] There is, however, a general conviction that in such a process the deposit is the cause and the loan is the result, but there is a possibility of a reverse relationship of cause and result.

Another crucial point for the desired results of the monetary policies is to know how monetary policy affects the economy and which monetary transfer channel works in the economy. In the loan channel, one of the monetary transfer channels, the monetary policy affects the real variables in the economy over the bank loans. This effect is more important for the economies where the banks serve as leading mediators and brokers in the financial system. Thus, the loans offered by the banks are influenced by the monetary policies, the change in the power of the banks to generate money, and the change in the ability of the firms to offer loans.[4] These channels consider the binding impact of the financial restrictions that are relevant to the presence of asymmetric information issues.[5] By the means of such channels, the monetary policy affects the cash flows, the net worth, and the external financial dependency in the business world.[6] As a result of these impact areas, the fund transfer costs that the firms bear because of asymmetric information are affected, resulting in change within bank loans.

The working of these monetary transfer channels implies a causal relationship between money supply and loans. There are many studies in the critical literature on this subject that offer empirical findings which provide evidence for the workings of such channels. Indeed, relevant entries to the aforementioned literature have been made by Ghazali and Rahman (2005), Said and Ismail (2007), Kassim and Majid (2009), and Hassin and Majid (2011); these figures have produced evidence for the existence and workings of these channels in the case of Malaysia; Sengönül and Thorbecke (2005), Bascı *et al.* (2007), and Aydın and Igan (2010) correspondingly produced evidence in the case of Turkey. It should, however, be noted that the empirical studies on Islamic banks, with reference to the loan channels, is relatively limited.

This study is then motivated by the limited empirical studies in the case of Islamic banks with regard to the subject matter, which aims to examine monetary supply and the bank money creation relationship in a comparative manner in Islamic and conventional banks for Turkey and Malaysia, with monthly data covering the period between January 2007 and May 2013. Such a comparison between Malaysia and Turkey is considered meaningful as both countries have a dual banking system, but they differ on the share of Islamic finance in total financing and the role of Islamic banking in the entire financial system. It should be noted that the Granger causality test is used as a method of analysis.

Islamic Banking and the Financial Sector in Malaysia and Turkey

The inception of Islamic (commercial) banking in Malaysia and Turkey can be traced back to the early 1980s. The liberalisation of the economy and finance sector during this period in Turkey provided an opportunity for the integration of Islamic banks (which were termed Special Finance Houses and which are now currently known as Participation Banks) with the objective of simultaneously attracting Gulf capital and aiming to overcome the financial exclusion due to religious reasons, namely the need to avoid interest or *riba* (Asutay, 2013). Consequently, the first Islamic bank or the Special Finance House was established in 1985. During the same period, Malaysia began its institutionalisation of Islamic banking based on some localised experience, such as Tabung Hajj, which had been in existence since 1969 as a *Shari'ah*-compliant investment agency for individuals' savings allocated to travelling for *hajj*. These efforts resulted in the incorporation of the first Islamic bank in Malaysia in 1983, which later developed into seventeen Islamic banks by the end of 2012. In this act, the search for Islamic identity played an important role alongside the need to locate an alternative development strategy for *Bumiputeras*, the indigenous Malay people.

Despite initiating the institutionalisation of Islamic banking around the same period, the trajectories of development in both countries have taken entirely different directions. Governments in Malaysia pursued rather intensive efforts to develop the sector by undertaking regulative-, legal-, institutional-, educational-, and training-oriented initiatives; the attitude in Turkey can, conversely, best be summarised as hesitant and timid (Asutay, 2013). The Malaysian policies paved the way for the development of the entire sector with the necessary infrastructure with the intention of getting Malaysia to become a global leader by reaching approximately 25% of the total banking sector in the country by 2015. As opposed to such progress, the Turkish experiment was mainly hampered by the political culture in the country, resulting in very slow growth path of reaching only approximately 5% of the banking sector in 2013 (Asutay, 2013). This difference can also be seen in the Islamic capital market developments, for although Malaysia is considered to be a leading *sukuk* market, Turkey only initiated *sukuk* issuance in recent years with the first corporate *sukuk* was issued in 2011.

There were fifty-six institutions including 17 Islamic banks offering Islamic financial services in Malaysia in 2012, yet this figure remained at only four institutions for Turkey (The Banker, 2012). This statistic also illustrates the entirely different trajectories of development and progress.

Table 1: Trends in Islamic Banking and Finance in Malaysia and Turkey

	***Shari'ah*-Compliant Assets in Malaysia (USD)**	**Share of Islamic Banks in the Banking Sector in Malaysia**	***Shari'ah*-Compliant Assets in Turkey (USD)**	**Share of Islamic Banks in the Banking Sector in Turkey (%)**
2007	65,083.37	15.5	10,065.96	3.35
2008	67,073.6	17.4	15,782.7	3.52
2009	86,288.2	19.6	17,827.5	4.03
2010	102,639.4	20.8	22,561.3	4.31
2011	133,406.38	21.8	28,015.20	4.41
2012	221,025.52	22.3	29,292.86	5.1

Source: The Banker (various years).

Data and Methodology

In responding to the aim of the study, causality analysis is considered to be instrumental; and for this, the Granger causality method (1969 and 1980) was employed as it helps to analyse the cause and effect relationship between two variables and the direction of this relationship or causality. In this methodology, if the expected value of one of the variables at a given time is affected by the past periods of the other series then the affecting variable is defined as the Granger cause of the affected variable.

The hypotheses that are tested in this paper using the Granger causality method are stated as follows.

H_0: Y is not the Granger cause of X.

$$X_t = \alpha_0 + \sum_{j=1}^{r} \alpha_j X_{t-j} + \sum_{j=1}^{r} \beta_j Y_{t-j} + \upsilon_t$$

H_0: X is not the Granger cause of Y.

$$Y_t = \alpha_0 + \sum_{j=1}^{r} \alpha_j Y_{t-j} + \sum_{j=1}^{r} \beta_j X_{t-j} + \upsilon_t$$

The significance of the causality relationship between these two variables depends on the coefficient produced by these equations. If the coefficients of the independent variable (β) are significant, it means that the Granger causality runs from the independent variable to the dependent variable. It should be noted that for the causality test, the series does, however, need to be stationary and there should be no cointegration relationship between the variables. Therefore, the stationary of the series for this paper was assessed by the Augmented Dickey-Fuller (ADF) test, and the cointegration relationship between the variables was measured by the Johansen cointegration test. In the event that there is a cointegration relationship between the variables then the error correction terms should be inserted into the models for the causality test.

This study used the monthly data sets for Malaysia for the period from January 2007 to March 2013 and for Turkey for the period from January 2007 to May 2013. All the data for Malaysia was obtained from the Monthly Statistical Bulletin on Bank Negara Malaysia; the data for Turkey was attained from the Electronic Data Dissemination System of the Central Bank of the Republic of Turkey.

For all analyses, the real value of variables was used; consumer price index (CPI, 2005=100) was employed to transform the current value of variables. In addition, all of the variables were deseasonalised by means of a Cesus 12 before the tests. The lag length in the Granger causality tests is determined by the consultation of Akaike's Information Criteria (AIC).

The variables used in the analyses are as follows:
CBD: Commercial Bank's Deposits
IBD: Islamic Bank's Deposits
CBL: Commercial Bank's Loans
IBL: Islamic Bank's Loans/Financing
M3: M3 Money Supply

The trends of the variables for both countries are shown in figures one and two. Similar trends thus emerge within the banking systems in both Malaysia and Turkey, yet for Malaysian Islamic and conventional banking, the fluctuations in the loans (financing) are more severe than the fluctuations in the deposits. This may mean that greater caution is needed in the liquidity management, and interest rate and profit-loss-sharing risk developments for the Malaysian economy.

Figure 1: Trends in the Malaysian Variables

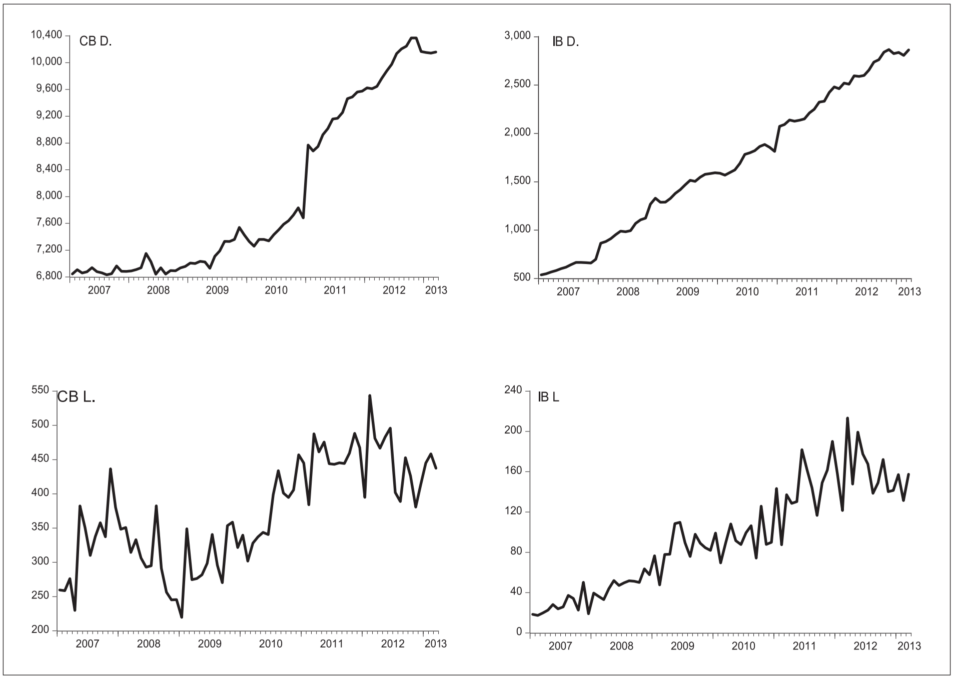
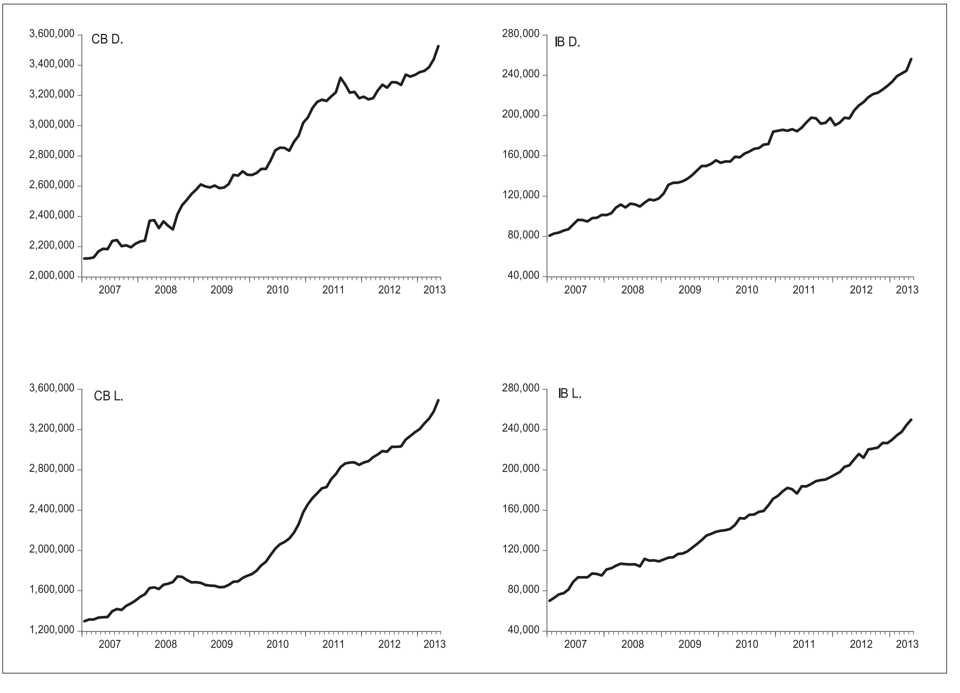


Figure 2: Trends in the Turkish Variables



In the next step before the application of the Granger test, the results of the unit root tests of the variables for both the countries are examined, and the results are presented in Table 2, which indicates that there is no unit root in the data series.

Table 2: The Results of the ADF Tests

	Level		First Dif.	
	t-Stat.	**Prob.**	**t-Stat.**	**Prob.**
		Malaysia		
CBD	-1.86389	0.6631	-9.25386	0
CBL	-2.12613	0.5225	-10.2781	0
IBD	-2.7492	0.251	-5.47098	0
IBL	-2.43365	0.302	-6.6546	0
M3	-1.65527	0.761	-8.30748	0
		Turkey		
CBD	-2.4138	0.3697	-6.35579	0
CBL	-0.98554	0.9394	-4.72086	0.0014
IBD	-1.39483	0.8548	-8.27992	0
IBL	-0.87839	0.9527	-9.5192	0
M3	-1.78135	0.7042	-5.83999	0

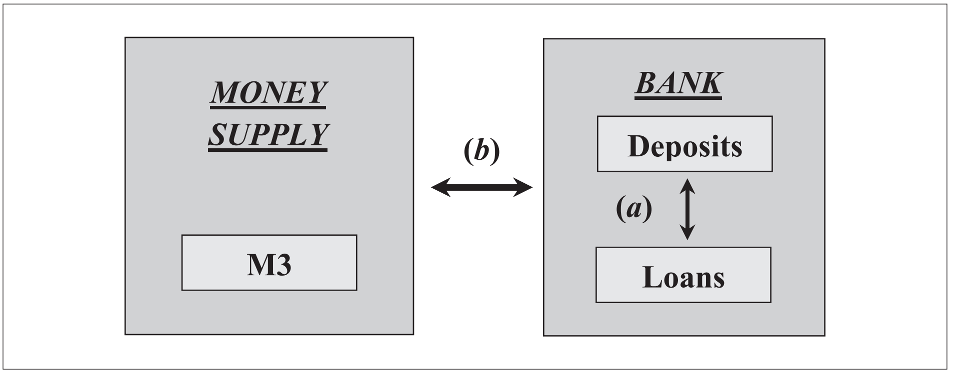
Analyses and Findings

This section presents the analyses that are related to the causality relationships between the following factors:

(i) The deposits and financing or loans of Islamic and conventional banks, denoted by (*a*);
(ii) Money supply and Islamic and conventional banks, denoted by (*b*).

Figure 3 summarises the tested causality relationships that are analysed by this paper.

Figure 3: The Operational Nature of the Model



The Causality Relationship between the Deposits and Bank Loans

In this section, the causal relationship between the deposits and loans of the conventional and Islamic banks are tested; the results are then compared for Malaysia and Turkey with the objective of determining the direction of the casual relationship in the generation of bank money within the two banking systems for both countries. Thus, the following relationship is tested:

Bank Deposits $\longleftrightarrow$ ***Bank Loans***

The results of the Johansen cointegration tests are illustrated in Table 3; the cointegration causality is then identified between the variables.

Table 3: The Results of the Johansen Cointegration Tests on the Deposits and Loans

		Eigenvalue	Trace	Prob.	Max-Eigen	Prob.
			Malaysia			
CBL and ***CBD***	None	0.151245	11.81606	0.166	11.80686	0.1181
	At most 1	0.000128	0.0092	0.9232	0.0092	0.9232
IBL and ***IBD***	None	0.129604	10.08582	0.2742	9.994083	0.2123
	At most 1	0.001273	0.091733	0.762	0.091733	0.762
			Turkey			
CBL and ***CBD***	None	0.056473	4.351795	0.8732	4.301626	0.8262
	At most 1	0.000678	0.050168	0.8227	0.050168	0.8227
IBL and ***IBD***	None	0.056213	6.53631	0.6321	4.281262	0.8286
	At most 1	0.030014	2.255049	0.1332	2.255049	0.1332

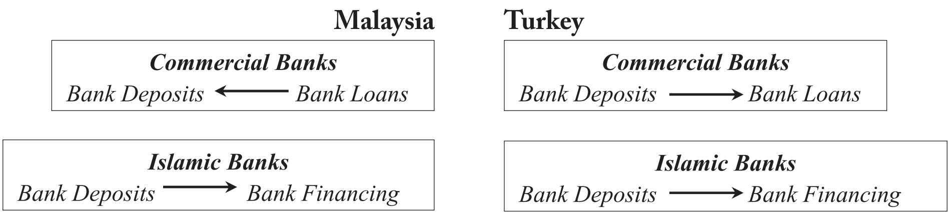
The results of the Granger causality analysis conducted with these variables are shown in Table 4.

Table 4: The Results of the Granger Causality Tests Between the Deposits and Loans

Direction of Causality	F_Stat.	Prob.	Lag
	Malaysia		
CBL→CBD	**2.43733**	**0.0368**	**6**
CBD→CBL	0.55419	0.7646	
IBL→BD	0.22121	0.8021	2
IBD→IBL	**6.80486**	**0.002**	
	Turkey		
CBL→CBD	1.44604	0.2425	2
CBD→CBL	**7.15161**	**0.0015**	
IBL→IBD	1.55464	0.1773	6
IBD →IBL	**2.84798**	**0.017**	

The results of Table 4 are summarised in Figure 4, which shows the direction of the casual relationship in generating bank money for both economies.

Figure 4: Summarising the Results for the Causality Tests Between the Deposits and Loans



Both Table 4 and Figure 4 establish the direction of the casual relationship between deposits and loans in both countries for Islamic banking. Thus, Islamic bank deposits Granger cause the funds/financing of these banks offer in both the countries. When compared to the Malaysian economy, it is found that this causal relationship is delayed for the Turkish economy.

With regard to the commercial banks, the direction of the causality is different in both countries: causality runs from the loans to the deposits in Malaysia, yet in Turkey it runs from the deposits to the loans. For Malaysia, commercial bank loans therefore appear to lead to further deposits in the financial system.

The Causal Relationship between Commercial Banks and Money Supply

Here, the causal relationship between money supply and the commercial banks' deposits and loans are analysed. For the functionality of the loan channel, causality from the monetary supply to the bank loans is essential. Therefore, finding the causality relationship from the money supply to the bank deposits indicates the presence of the monetary channel, as is expressed by the following arrangement.

Commercial Banks
Money Supply ⟷ ***Deposits***
Loans

The results of the cointegration tests on the variables are presented in Table 5 indicating the presence of no cointegration.

Table 5: The Results of the Johansen Cointegration Tests on the Variables and Money Supply for Commercial Banks

		Eigenvalue	Trace	Prob.	Max-Eigen	Prob.
			Malaysia			
CBD and ***M3***	None	0.1633	13.07427	0.1121	12.83686	0.083
	At most 1	0.003292	0.237412	0.6261	0.237412	0.6261
CBL and ***M3***	None	0.139324	10.82458	0.2225	10.80263	0.1644
	At most 1	0.000305	0.021944	0.8822	0.021944	0.8822
			Turkey			
CBD and ***M3***	None	0.085358	6.649717	0.6187	6.602438	0.5372
	At most 1	0.000639	0.047279	0.8278	0.047279	0.8278
CBL and ***M3***	None	0.068959	5.468067	0.7573	5.28742	0.7052
	At most 1	0.002438	0.180647	0.6708	0.180647	0.6708

After ensuring the presence of no cointegration, Table 6 displays the results of the Granger causality test analysis between the variables of commercial banks and money supply.

Table 6: The Results of the Granger Causality Tests Between the Variables and Money Supply for Commercial Banks

Direction of Causality	F-Stat.	Prob.	Lag
	Malaysia		
M3→CBD	0.535	0.5881	2
CBD→M3	0.249	0.7799	
M3→CBL	**3.915**	**0.0518**	**1**
CBL→M3	1.173	0.2826	
	Turkey		
M3→CBD	**8.07386**	**0.0007**	**2**
CBD→M3	2.19866	0.1187	
M3→CBL	**3.91661**	**0.0516**	**1**
CBL→M3	2.70198	0.1046	

The results presented in Table 6 are summarised by Figure 5, which illustrates the direction of the Granger causality.

Figure 5: Summarising the Results for the Causality Tests Between Money Supply and Bank Deposits and Bank Loans

Malaysia	***Turkey***
	Money Supply → Bank Deposits
Money Supply → Bank Loans	*Money Supply → Bank Loans*

As can be seen from the results, the identification of the causal relationship from the money supply to the commercial bank loans shows that the loan channel works over the commercial banks in both economies. This result confirms the empirical findings in the available literature. In addition, the causal relationship is found to be running from the money supply to bank loans in the case of Turkey, whereas there is no such relationship for the Malaysian economy.

The Causality Relationship Between Islamic Banks and Money Supply

Here, the causal relationship between the money supply and deposits and financing for the Islamic banking variables is examined for both Malaysia and Turkey; it is summarised as follows:

In the first step, cointegration is investigated for all of the variables for both countries, and the results are depicted in Table 7.

Table 7: The Results of the Johansen Cointegration Tests on the Variables and Money Supply for the Islamic Banks

		Eigenvalue	Trace	Prob.	Max-Eigen	Prob.
			Malaysia			
IBD and ***M3***	None	0.05356	3.988147	0.9045	3.963432	0.8632
	At most 1	0.000343	0.024715	0.875	0.024715	0.875
IBL and ***M3***	None	0.136662	10.6155	0.2363	10.58036	0.1765
	At most 1	0.000488	0.035141	0.8513	0.035141	0.8513
			Turkey			
IBD and ***M3***	None	0.081467	9.422522	0.3277	6.28836	0.5765
	At most 1	0.041469	3.134162	0.0767	3.134162	0.0767
IBL and ***M3***	None	0.057549	7.233189	0.5507	4.386045	0.8165
	At most 1	0.037744	2.847144	0.0915	2.847144	0.0915

As can be seen in Table 7, the Johansen cointegration test results show no cointegrated relationship. Based on this result, Table 8 presents the results of the Granger causality test for Islamic banks in both countries.

Table 8: The Results of the Granger Causality Tests Between the Variables and Money Supply for the Islamic Banks

Direction of Causality	F_Stat.	Prob.	Lag
	Malaysia		
M3→IBD	0.49151	0.6139	2
IBD→M3	1.28159	0.2843	
M3→IBL	**3.01627**	**0.015**	**19**
IBL→M3	1.42564	0.2391	
	Turkey		
M3→IBD	**3.29134**	**0.0738**	**1**
IBD→M3	0.0018	0.9663	
M3→IBL	1.45433	0.2183	5
IBL→M3	**3.1755**	**0.0131**	

The results of Table 8 are summarised in Figure 6.

Figure 6: Summarising the Results for Causality Tests between Money Supply and Islamic Bank Deposits and Financing

Malaysia	***Turkey***
Money Supply $\longrightarrow$ *Bank Financing*	*Money Supply* $\longrightarrow$ *Bank Deposits*
	Money Supply $\longleftarrow$ *Bank Financing*

For Malaysia, the results indicate that the direction of causality is the same for commercial bank loans and the Islamic banking financing; as is the case for Islamic banks, the causality runs from *M3* to financing. The causality does, however, work in the reverse direction for the Turkish economy, thereby implying that Islamic bank financing affects *M3* or money supply. In addition, the results suggest that money supply in the economy determines Islamic bank deposits in Turkey. These results indicate that the financing (loan) channel works for Islamic banks for Malaysia, whereas the same channel does not work over the Islamic banking in Turkey. It can then be inferred that the Islamic interbank market will remain a problem in Turkey. With the operation of the Islamic money market in Malaysia, this has provided the opportunity to affect the economy through central bank operations over Islamic banks, whereas the lack of an Islamic money market in Turkey implies that the central bank has no such power to influence the Islamic bank financing in Turkey. This distinction can again be explained by Malaysia's concerted effort to provide the necessary infrastructure for the smooth operation of Islamic banks within the country.

Conclusion

This study analyses the direction of causal relationships in bank money creation and money supply by using monthly data sets (covering the period between 2007 and 2013) for Islamic and conventional banks in Malaysia and Turkey; further, it employs the Granger causality method. The results are described in detail throughout section four of this study and they are summarised in Figure 6.

It should be noted that although it could be the case that this method may not be sufficient to determine the transfer channel alone, the comparison of the results from two banking systems in both countries offers an opportunity to understand the direction of causality in the bank money creation, as well as informing the efficiency and the functionality of the loan or financing and monetary channels in both banking systems.

The results show that the direction of causality between loans (financing) and deposits is the same in both countries for Islamic banking: the funds that the Islamic banks collect in both countries are the Granger cause of the funds these same banks offer in financing. This result fulfils the theoretical expectations in relation to use of the collected funds. When compared to the Malaysian economy, this causal relationship is, however, found to be appearing with delays for the Turkish economy.

With regard to the conventional banks, the results reveal that the direction of causality is different in both countries. In Malaysia, causality is determined from loans to deposits, whereas the direction of causality is from deposits to loans in Turkish conventional banking. Thus, Turkish conventional and Islamic banks show similar causal directions.

Figure 6: Summarising the Results

Malaysia	**Turkey**
Conventional Banks *Bank Deposits* ← *Bank Loans*	***Conventional Banks*** *Bank Deposits* → *Bank Loans*
Islamic Banks *Bank Deposits* → *Bank Financing*	***Islamic Banks*** *Bank Deposits* → *Bank Financing*

With regard to the causality between money supply and deposits and loans, the results show that the money supply has an impact on both banking systems in both countries. For both economies, the direction of causality between money supply and the conventional bank loans is determined to be from money supply to the bank loans. This shows that for both economies, the loan channel works over conventional banks. Given that conventional banks have a larger share in the financial system, the working of this channel is important when conducting the monetary policies.

Malaysia	***Turkey***
Money Supply → *Bank Loans*	*Money Supply* → *Bank Loans*

With regard to the causality relationship on the conventional bank deposits, the results demonstrate that the causal relationship between the deposits and money supply is only present in Turkey. The direction of this causal relationship conforms to the working of the money channel. Therefore, the monetary channel can be considered as present and working for Turkey.

Turkey

Money Supply → *Bank Deposits*

Similar analyses were also conducted for Islamic banks in this study. For Malaysia, the direction of the causality found for conventional banking is seen to be valid for Islamic bank financing, yet the direction of the causality is in the opposite direction for Turkey. These results indicate that the probability of having the financing channel working for Malaysia over Islamic banks is higher than that of the same channel not to be working over Islamic banking in Turkey.

Malaysia

Money Supply → *Bank Loans*

Turkey

Money Supply → *Bank Deposits*

Money Supply ← *Bank Loans*

Furthermore, this study finds that the causal relationship between the money supply and Islamic bank financing is found to be taking place with delays in both countries implying that the impact of any change in money supply on the financing of Islamic banking emerges with delay. This situation may lead to differentiation in the reaction to change in the money supply of the firms and sectors using loans and financing from both banking systems. In addition, depending on the magnitude of the differences of the potential reaction and the relative size of the Islamic banking in the country, this may affect the efficiency of the monetary policy. To ensure that such a situation does not lead to the loss of efficiency, the need may arise to use the instruments of Islamic monetary policy more effectively, which needs to be developed in order to help Islamic banks to function properly.

Ultimately, in both countries, the loan channel works over conventional banks, whereas this only works over Islamic banks in Malaysia. It should be noted that the money channel or the money supply-deposit relationship is stronger in Turkey than it is in the case of Malaysia. The possibility of the financing channel working relatively weaker over Islamic banking in Turkey may, however, create problems in the distribution of the impact of monetary expansion and contraction in terms of the monetary management. The possibility of this situation causing any potential problems is related to the size of Islamic banking. Even though the size of Islamic banking represents approximately 5% of the financial system in terms of its asset base in Turkey (see Table 1), this potential issue should still be taken into consideration by the Central Bank of Turkey to prevent it from developing into a problem. In addition, the similar asymmetric impact for both countries should also be taken into account with regard to the differences in the delay periods. The absence of an Islamic interbank market in Turkey could, however, potentially lead to problems on a macro level. In the future (and echoing the development of the size of Islamic banking), when the functioning of the financing channel over Islamic banking gets stronger, the absence of an Islamic interbank market in Turkey may result in financial and operational difficulties. This constitutes the essential reason for the development of such infrastructural institutions, which can be instrumental for the consolidation and sustainability of the Islamic banking sector in Turkey.

Endnotes

1 See Mishkin (1995) for a detailed discussion of the monetary transmission mechanism.

2 "Money does not have any inherent value in itself and therefore money cannot be created through the credit system, thereby providing another rationale for the prohibition of interest" (Asutay, 2010: 39). For a detailed discussion, see Chapra (1985).

3 Hasan (2008 and 2011) notes in his studies, wherein bank money generation is evaluated with regard to the Islamic framework, that money is not a religious concept. Despite differences in the process of generating bank money, Hasan also refers to similarities and suggests that central banks should develop tools and mechanisms, which could affect the Islamic banks' ability to generate money.

4 There are two major loan channels that could be described as a bank loans channel and a balance channel operating over the bank loans (Mishkin, 1995). In the bank loans channel, based on the power of the banks to generate money, the opportunities of the banks to offer loans react to the monetary policies (Bernanke and Bilinder,

1992; Kashyap and Stein, 1993; Kashyap et al., 1993). Another loan channel, which could be termed a balance sheet or net value channel, reacts to the monetary policy because of the financial restrictions of firms (Bernanke and Gertler, 1995; Calomiris and Hubbard, 1990).

5 Asymmetric information can affect the cost of funds in financial markets (Hubbard, 1998).

6 The external finance premium, which refers to the difference between internal and external finance cost, is reversely affected by the net worth of the firms (Bernanke et al., 1996).

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Integration of the Participation Banking Legislations to the Banking Law and its Influence on Competition

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Abstract

In some countries such as Turkey, Islamic banks and conventional banks coexist in banking industry. However, due to dissimilarities in their business models, these institutions may be subject to different statutory and regulatory arrangements. The arrangements in a dual banking system might repel potential customers from Islamic banks if privileged arrangements are solely open to conventional banks. Up until late 2005, Islamic banks in Turkey were recognized as "special finance houses" and were exempt from the rights that covered conventional banks, like deposit coverage. As an interesting case, the legislative changes in late 2005 have eliminated the deprivations and provided more constructive environment for Islamic banks. Yet, what these legislative changes have brought about for Islamic banks is still unexplored. In this paper, we study the effects of the legislative changes in Turkish Islamic banking on market structure. The results reveal that Islamic banks gained more market power after the enactment of various legislations and integration of these legislations to the Banking Law.

Keywords: *Market structure, competition, Islamic banks, participation banks, policy reforms*

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Introduction

The 2008 global financial crisis (hereafter 2008 crisis) was caused by the intertwined fragilities that arose in the financial sectors. The on-going debates relate 2008 crisis to loose regulation and accommodative monetary policy that stimulated financial institutions to do business without assessing the risk correctly (Diamond and Rajan, 2009; Obstfeld and Rogoff, 2009)[1]. Ensuing to the failures of financial institutions worldwide, central banks and global financial institutions have engaged in collaboration to overhaul the shattered financial system. These institutions have initiated several joint regulatory measures to mitigate excessive risk taking. Beyond these on-going regulatory efforts worldwide, 2008 financial crisis clearly demonstrated an urgent need for rethinking the existing banking scheme. In this context, Islamic banking received more attention in global finance (Čihák and Hesse, 2010; Beck et al., 2013). Particularly, profit and loss sharing (PLS) based business model that is unique to Islamic banks is increasingly considered to be conducive to financial stability.

The growing interest toward Islamic banking on the globe reflected in a series of favourable legislative and regulatory changes for Islamic (participation) banks in Turkey. Thanks to positive climate created by these changes, Islamic banks have shown considerable growth and diversified their asset portfolio with new *Shariah* compliant securities, e.g. *sukuk* (rent certificates), revenue indexed bonds. Although positive developments with the introduction of these recent changes are visible, the scholarly research investigating the impact of legislative and regulatory changes on Islamic banks is still lacking. This study attempts to fill this gap by investigating the impact of enactment of various legislations and integration of these legislations to the Banking Law on the market power of Islamic banks.

Recent studies on the market structure of the Turkish banking solely studied conventional banks (see Gunalp and Celik, 2006; Abbasoglu et al., 2007, Aktan and Masood, 2010). Yet, the market structure of the Turkish banking with a specific interest to Islamic banking sector is not investigated at all. By employing the Panzar-Rosse model (hereafter P-R model), this study assesses the degree of competition in Islamic banking during January 2001- January 2013 period. Based on a balanced panel dataset of monthly data, the study analyzes the market structure and competition in the Turkish Islamic banking for the *pre-reform* and *post-reform* periods when the reform refers to the enactment of various legislations and integration of these legislations to the Banking Law in 2006.

On the outset of Islamic banking in Turkey, Moore (1990) indicated potential threats to competition among Islamic banks and warned that these banks might simply replicate the oligopolistic behaviour of the established business groups in the country. He argued that due to close relationship between the political elites and the banks of the time, these banks could enjoy oligopolistic structure of the banking system (Moore, 1990:249). This study reopens this debate that Moore (1990) has elicited a while ago by thoroughly examining the market structure of the sector in the last decade. The findings of this study suggest that the market structure in Turkish Islamic banking changes after the implementation of various legislations and integration of these legislations to the Banking Law in 2006. Estimated P-R *H*-statistics clearly indicate an increasing market power for the Islamic banks and the market structure reverses from monopolistic competition to monopoly.

The remainder of this paper is organized as follows. In Section 2, we give an overview of the Islamic banking sector in Turkey. In Section 3, the P-R methodology and empirical model used for the analysis are briefly explained. Section 4 presents the data and the estimation results. In this section, we test whether the reforms in late 2005 have changed the market structure or not. The last section concludes with policy-implications.

Islamic Banking in Turkey

Turkish banking sector has witnessed substantial reforms over the last decade after a long period of weak performance. Recent regulatory reforms have dealt with the drawbacks in the sector by exercising various guiding changes. The triggering effect of the reforms has been the banking crisis in 2001 (hereafter 2001 crisis). Undoubtedly, the 2001 crisis caused a tremendous havoc in the economy. Nearly 50 percent of the bank deposits were withdrawn by depositors, and over 20 insolvent banks were transferred to the Savings Deposit Insurance Fund of Turkey (SDIF) during the crisis (see Aysan et al., 2011). Yet, the stark evidence demonstrated that Islamic banks in Turkey were able to survive and steadily grow with minor corrections after these distressed times.

Some claimed that the Islamic banks in Turkey stayed more resilient than the conventional banks during 2001 crisis thanks to the Islamic finance model that they have to strictly adhere to[2]. During the 2001 crisis, profit and loss sharing helped Islamic banks avoid from the skyrocketed interest rates that hit the conventional banks severely. When the conventional banks created open positions with unbearable interest rates, the Islamic banks prevented from this massive exposure. Therefore just contrary to the conventional banks, the Islamic banks have shielded from the adverse market movements to great extent. Moreover, Islamic banks have also carried less foreign currency risk by not creating any interest rate risk through open foreign currency position. At that time, huge foreign exchange open positions put many conventional banks at risk since most of the banks in the sector used to be earning lucrative spread returns from interest rate differentials between domestic and international markets.

Arguably, Islamic banks were restricted by both Islamic principles and regulatory arrangements in Turkey. The first dimension of the limitation was due to its very nature that the prohibition of investment in fixed income securities deprives Islamic banks of lucrative returns in Turkish banking. The second dimension was the restrictive regulatory arrangements that put Islamic banks in a disadvantageous position. In its short history, relative success of Islamic banks was not very much supported by the regulatory treatments. For example, till 2005 these banks had been somehow exempt from a series of privileges provided to the conventional banks, such as the deposit insurance scheme. Furthermore, an interbank-like market for the Islamic banks does not exist in Turkey which left the Islamic banks highly exposed to illiquidity difficulties during distressed times (Syed Ali, 2006).

Islamic banks which exist in Turkish banking for more than three decades are prone to significant changes nowadays. Once a negligible sliver of the banking industry; Islamic banking sector has been growing steadily in recent years. The legislative changes enacted in late 2005 are shown as the principal factor for this improvement.

Regulations

The history of Islamic banking in Turkey goes back to 1983 when a number of financial institutions under the name of *special finance houses*

(SFHs) have entered into the banking industry by a governmental decree. Arguably, the reasons for the establishment of this decree were twofold. First of all, having scarce foreign exchange reserves at the time, the policy makers aimed at attracting additional resources from Gulf countries. Under the pressure of severe foreign currency needs, the government at that time treated the Islamic banks as a safe pool of foreign currency resources. Secondly and probably more importantly, religiously devoted people who were reluctant to invest in interest based products were targeted to be included in the financial system with the new *Shariah*-compliant products.

Shortly after the decree, *Al-Baraka Turk and Faisal Finance House*, both established in 1984, have entered into the Turkish financial system as the first SFHs. *Kuveyt-Turk Finance House* followed these two in 1988, bringing the number of SFHs to three. The majority ownership of these three SFHs was initially foreign, yet by 1991 three new SFHs were opened up with 100 percent domestic capital. With this wave, *Anadolu Finance House, Ihlas Finance House,* and *Asya Finance House* took their places in the system. This upsurge in Islamic banking is often perceived as a conduit for the religiously devoted people in Turkey to channel their accumulated capital to the financial sector.

The regulations governing the operations of SFHs went through several changes. Before 1999, SFHs were subject to the *Interest-free Banking Decree No.83/7506* and were monitored and supervised by the Undersecretariat of the Treasury and Central Bank of Turkey. This decree dealing with the foundation, operation, and liquidation of the SFHs did not provide fair competition for the Islamic banks and hence generate an environment relatively more favourable for the conventional banks (El-Gamal and Inanoglu, 2000). Since SFIs are governed by a governmental decree instead of a law as in the case of conventional banks, their regulatory status put these institutions under great uncertainty. Certainly, these institutions were not "banks" in essence, but fulfilled many operations similar to the conducts of the conventional banks. Besides the name "special finance house" created an illusion on the depositor side as if these banks were not doing "banking".

Till 1999, SFHs have neither been a part of the banking industry nor have they been governed by a proper legislative framework. These institutions have been mainly administrated by various legislations which aggravated the opaqueness as to their legal status. Yet, partly due to the new entrants that had been initially owned 100 percent by the domestic capital, existing SFHs became subject to the new *Banking Act No: 4389* and *4491*, effective 19 December 1999, which improved their already weak competitive position with respect to the conventional banks. Although several regulatory disadvantages have still persisted, becoming subject to this new law, these institutions have been reframed by law and gained the "complementary bank" standing instead of "alternative finance house" status.

2001 crisis has brought wide-ranging adjustment for the Turkish banking sector. The adjustments encompassed two major regulatory developments for the Islamic banks, namely the establishment of *Special Finance Houses Association* (SFHA) and the introduction of *Deposit Insurance Fund* for SFHs which was administered by the SFHA. At the time, a deposit insurance scheme provided by the state itself covered solely the conventional banks to prevent potential bank-runs during the crisis. Without accepting SFHs under the same scheme, the duality of conventional banks versus SFHs remained unresolved. Hence, the competitive disadvantage of SFHs sustained during the restructuring of the banking sector (Akin et al. 2009 and 2011).

Unfavorable regulatory treatment of the SFHs has come to the end with the *Banking Act No: 5411*, effective 1 November 2005. In the new law, the name "special finance houses" is replaced with "participation banks". After alleviating the ambiguities over the status of these institutions, the banking sector is currently composed three types of banks: (i) commercial banks, (ii) development and investment banks, and (iii) participation (Islamic) banks. These alterations meant an official acknowledgement of the Islamic banks to be treated similar to the conventional banks in the sector. Treatment of SFHs similar to the conventional banks has several vital implications. Firstly, uncertainty and hesitations toward these institutions due to their names was ameliorated. With the new status as "participation banks", these institutions, from a regulatory perspective, started to operate just like other banks in the industry. The new law has also given an explicit guarantee for the customers of these institutions to have same rights of the customers of the conventional banks in the sector. Besides, the deposit insurance used to be covered by SFHA beforehand were transferred to the SDIF. Last but not the least, the confusion in cross-border operations caused by naming these banks as "special finance houses" that had no use elsewhere other than Turkey has ended up.

Product Diversification

Apart from the statutory progress in Islamic banking, authorities have initiated numerous regulatory changes that enabled product diversification in the sector. The new changes paved the way for sukuk[3] issuances for the general government financing as well as for the corporate financing. Thanks to newer regulatory changes applicable for the corporates, banks, and the government, it is now easier to reach to a wider pool of investors who were unable to transact Turkish originated debt. Apart from government financing turn-over in the country, gloriously growing economy with a vast web of infrastructural and industrial projects attracts the investor community. According to Ernst & Young (2012) estimates, as of 2023, Islamic banking in Turkey could triple in size and reach to more than USD 100 billion approximately where the size of Malaysia's Islamic banking is today. Apart from the regulatory changes that enabled the issuance of various Shariah compliant financial products, the tax law was also amended to facilitate the process whereby Turkish issuers could raise long term Islamic financing[4]. Certainly; the legislative and regulatory changes have prompted favourable climate for the Islamic banks in Turkey. However, their effects on the market structure are not empirically explored. Given the need for such an analytical appraisal of the topic, this paper attempts to investigate this question empirically.

Model and Estimation

The Panzar-Rosse Model

Measurement of competition generally follows two approaches in the literature: the structural and the non-structural methods. The structural approach in measuring competition which underpins the structural-conduct-performance (SCP) paradigm links market power to the degree of market concentration. This approach presumes lower/higher competition in concentrated/less-concentrated markets. Concentration based measures of competition are subject to criticism on the ground that concentration can be resulted from a greater efficiency, or competition eliminates less efficient ones (Demsetz, 1973). On the other hand, non-structural models of competitive behaviour within the context of the New Empirical Industrial Organization (NEIO) approach derive the measures on competition from market behaviour. Bresnahan (1982) and Lau (1982) suggest a procedure that comprises the estimation of a simultaneous equations model based on industry-level data where a parameter representing the degree of market power of firms is incorporated. An alternative method within NEIO approach that has the advantage of using bank-level data involves the estimation of the P-R model.

The P-R model popularized by Rosse and Panzar (1977) and Panzar and Rosse (1987) is an approach that measures competition by relying on a reduced-form revenue equation. Panzar-Rosse (1977, 1987) proposed a formal method to assess the degree of competition in a market, solely by observing the individual firms' behaviour. According to the model, the level of competition in the market can be obtained from the sum of input price elasticities (the so called *H*-statistic). The intuition behind this method is fairly straightforward. A firm's monopoly power is observable by its pricing decisions. With a reduced form revenue equation including the prices of inputs, the ability of the firms to pass the effects of a change in its input prices to the output price reveals its monopoly power. The choice of P-R model in measuring the competition is based on three virtues. First, aside from the long-run equilibrium assumption, it has no *a priori* assumption. Second, it has strong theoretical background and formal proof. Third, the data employed in estimating the revenue and profit functions are highly standard and easily accessible bank-level data.

P-R model assumes that banks have revenue and cost functions, given as $\mathrm{R_i}(\mathrm{y_i}, \mathrm{n}, \mathrm{z_i})$ and $\mathrm{C_i}(\mathrm{y_i}, \mathrm{w_i}, \mathrm{t_i})$ respectively where R_i and C_i are respectively the revenue and cost of bank i; $\mathrm{y_i}$ is the output of bank i; $\mathrm{w_i}$ is a vector of input prices for bank i; n is the number of banks; and $\mathrm{z_i}$ and $\mathrm{t_i}$ are vectors of relevant exogenous variables with respect to the revenue and cost functions. The first order profit maximization condition requires that marginal revenue is equal to marginal cost, $\mathrm{R}'_\mathrm{i}(\mathrm{y_i}, \mathrm{n}, \mathrm{z_i}) = \mathrm{C}'_\mathrm{i}(\mathrm{y_i}, \mathrm{w_i}, \mathrm{t_i})$, where R'_i and C'_i are respectively marginal revenue and marginal cost of bank i. Long-run equilibrium in the product market imposes a zero profit constraint, that is $\mathrm{R}^*_\mathrm{i}(\mathrm{y}^*_\mathrm{i}, \mathrm{n}^*, \mathrm{z_i}) = \mathrm{C}^*_\mathrm{i}(\mathrm{y}^*_\mathrm{i}, \mathrm{w_i}, \mathrm{t_i})$, where the asterisked values are the equilibrium values of the first order condition which is previously defined.

The *H*-statistic is, then, derived as the sum of factor price elasticities, that is $\sum_{\mathrm{k=1}}^{\mathrm{m}} \frac{\partial \mathrm{R}^*_\mathrm{i}}{\partial \mathrm{w_{ki}}} \frac{\mathrm{w_{ki}}}{\mathrm{R}^*_\mathrm{i}}$, where $\frac{\partial \mathrm{R}^*_\mathrm{i}}{\partial \mathrm{w_{ki}}}$ is the derivative of total revenue with respect to the price of the input. According to the value of *H*-statistic there exist three scenarios: monopoly, monopolistic competition, and perfect competition.

i) The case of monopoly refers to *H*-statistic that is zero or negative ($H \leq 0$), implying that an increase in factor prices leads to a fall in revenue. This is particularly the case since the monopolist operates at the price elastic portion of the demand curve where an increase in product price in response to an increase in input price(s) leads to a more than a proportional fall in units sold that causes revenue fall.
ii) The case of monopolistic competition refers to *H*-statistic that is between zero and one ($0 < H < 1$). Here, an increase in factor prices increases average and marginal costs. This causes some banks to fail and subsequently lead to an increase in revenue.
iii) In the case of perfect competition, an increase in factor prices causes revenue to increase proportionally. Thus, $H=1$ implies perfect competition.

It must be underlined that the P-R model relies on the assumption that banks are at their long-run equilibrium. Long-run equilibrium further requires that (risk-adjusted) returns are not statistically significantly correlated with input prices (Shafer, 1982). The application of the model to the banking sector further assumes that banks can be treated as single-product firms offering intermediation services (De Bandt and Davis, 2000).

Starting from Shafer (1982), the P-R model has been extensively applied to the banking industries. Earlier studies employed cross section data sets to examine the market structure in banking sector. Using a sample of US banking data for the period 1979, Shafer (1982) identifies a monopolistic competitive banking behaviour. Other earlier applications of the model were for the Canadian banks (Nathan and Neave, 1989), European banks (Molyneux et al., 1994) and Japanese banks (Molyneux et al., 1996). Nathan and Neave (1989) find monopolistic competition in the Canadian banking sector for the period 1983 and 1984 but perfect competition in the period 1982. Recent studies employ panel data to explore the time series properties of banking data. These include Al-Muharrami et al. (2006) for the Arab Gulf Cooperation Council's (GCC) banking system; Bikker and Haaf (2002) for 23 European Union and non-European Union countries; Coccorese (2004) for the Italian banking system; De Bandt and Davis (2000) for a sample of French, German, Italian and US banks;

Hondroyiannis et al. (1999) for the Greek banking system; Mamatzakis et al. (2005) for a sample of South East European countries; and Perera et al. (2006) for South Asian banking sectors. The results of the above studies are mostly consistent with the monopolistic competition, where *H*-statistic lies between zero and one.

Estimation

In order to decide the degree of competition, we estimate the following reduced form revenue model:

$$\mathrm{lnRev}_{it} = \alpha + \sum_{j=1}^{3} \beta_j \mathrm{lnW}_{j,i,t} + \sum_{k=1}^{3} \delta_k \mathrm{lnW}_{k,i,t}\mathrm{Reform}_t + \sum_{l=1}^{m} \sigma_l X_{l,i,t} + \varepsilon_{i,t} \qquad (1)$$

where subscripts i and t refer to bank i at time t; Rev_{it} is total revenue of bank at time t; W_k and W_j are a three-dimensional vector of input prices, namely, the unit price of fund (*PF*), unit price of labour (*PL*) and the unit price of capital (*PC*); X_l is a vector of bank specific explanatory factors which may shift the revenue and cost functions; and is the i.i.d. error term with mean 0 and variance $\sigma_{i,t}^2$.

Following the present literature, *PF* is measured as the ratio of total interest expenses[5] to total deposits *PL*; is measured as the ratio of personnel expenses to number of personnel; and *PC* is proxied by the ratio of other operating expenses to fixed assets. Bank-specific explanatory variables that are selected in relevance to the literature include *Liquidity Risk* measured as (total assets-total credits-fixed assets)/deposits to account for banks' credit risk exposure. *Solvency Risk* is measured as shareholders' equity/total assets to proxy solvency risk, i.e. banks' leverage. *Relationship banking* variable is calculated as the ratio of total number of bank personnel to total assets. *Bank age* is the natural logarithm of the number of months the bank exists to proxy the maturity of institution. *Bank branch* is the natural logarithm of the number of bank branches. *Reform* is the dummy that takes 1 for the months starting from 2006 and onwards, 0 otherwise to capture the impact of the legislative and regulatory changes on market power.

We expect the sign of the *Liquidity Risk* to be negative since staying on liquid assets pulls back the revenues especially generated from extended credits. Higher *Solvency Risk* value reflects a lower risk in the sense that the bank in question is not highly leveraged, i.e. asset portfolio is affordable in terms of capital adequacy. Therefore, we expect a positive sign for this variable. Calculated as the total number of bank personnel to total assets, *Relationship banking* is expected to enter into the equations with negative sign. We justify this expectation with banks' on-going motivation to grow in personnel size that puts increasing cost pressures to the institution during the last decade. *Bank age* is associated with the maturity of institution and thus reflects the trust toward the institution. The expected sign for this variable is positive, since mature banks are expected to attract more customers. The coefficient of *Bank branch* should be positive since banks with higher number of branches are expected to earn higher revenues.

To test for the long-run equilibrium, the equation (1) is estimated with the return on asset (*ROA*) as the dependent variable:

$$\ln ROA_{it} = \alpha + \sum_{j=1}^{3} \beta_j \ln W_{j,i,t} + \sum_{k=1}^{3} \delta_k \ln W_{k,i,t} Reform_t + \sum_{l=1}^{m} \sigma_l X_{l,i,t} + \varepsilon_{i,t} \qquad (2)$$

Following to the estimation of the equation (1), P-R *H*-statistic is obtained for *pre-reform* period as the sum of the coefficients of factor prices as follows:

$$H = \sum_{j=1}^{3} \beta_j$$

The P-R *H*-statistic for *post-reform* period is obtained by including the sum of the coefficients of interaction terms as:

$$H = \sum_{j=1}^{3} \beta_j + \sum_{k=1}^{3} \delta_k$$

Data and Estimation Results

Data

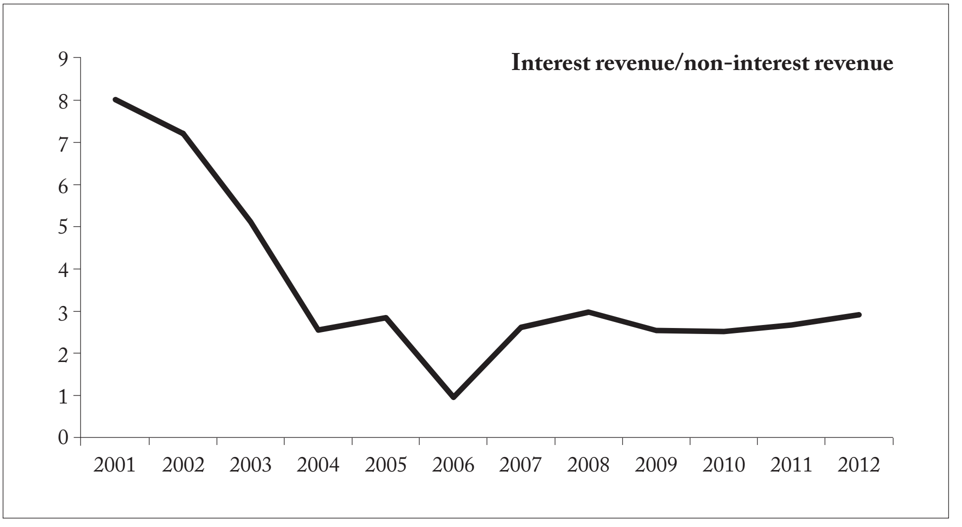
The novel database used in this study is composed of information from monthly balance sheet and income statement of all Islamic banks in Turkey from January 2001 to January 2013. We employ a balanced panel date set of four Islamic banks. Actually, the number of Islamic banks before 2005 was five. Yet, *Anadolu Finance* and *Family Finance* in the system had decided to merge. Therefore, the financial accounts of these two institutions which have merged during our sample period were added up and reported as a single bank. The rationale behind following this procedure is that the merger date coincides exactly with the date of the dummy which takes 1 after November 2005. Our methodological approach is designed (i) to infer the market structure of Islamic banking before the legislative and regulatory changes has taken place, and (ii) to address the competitive changes after the introduction of these changes in the banking sector. Ahead of using the raw data, we winsorize the dependent variables, bank risk variables, and the input prices at the 2% level in both tails to moderate the distortive influence of extreme values.

Estimation Results

Following the existing literature, we estimate the models using bank fixed effects to control for the unobserved heterogeneity across banks. To control for potentially heteroscedastic and potentially correlated error terms within a cross section, we estimate heteroscedastic and autocorrelation consistent standard errors. Furthermore, we consider yearly time fixed effects in a separate estimation to account for the macroeconomic fluctuations and possible trends that might influence the revenue indicators. By doing so, the potential effects of 2008 crisis on banks' revenue are captured.

Table-1 reports the estimation results both for *pre-reform* and *post-reform* period. The first column presents results for the fixed effect estimator for only bank dummies, whereas the second column takes into account time dummies as well. The results for the re-estimation of the models with non-interest revenues as the dependent variable are presented in the third and fourth columns respectively. The investigation of the market structure over non-interest revenues is justified by the fact that Islamic banks increased their non-interest revenues during the sample period. Throughout the years, by scanning through the banks' financial statements, we observe a positive turn towards the diversification in sources of a bank's revenues. This is evident in Figure-1 where increasing volume of non-interest revenue over total revenue is visible on a bank's balance sheet.

Figure-1. The share of interest revenue in non-interest revenue (2001-2012)



It is seen from Table-1 that the sign of the coefficient estimates for PF is always positive and statistically significant at various significance levels, while the coefficient estimates of PK and PL are always insignificant with changing signs. The coefficient estimate of *Liquidity Risk* is negative as expected but mostly insignificant. Then, its negative sign suggests that the banks that have much liquid assets fall short of generating high revenues. The models capture positive relationship between *Solvency Risk* and dependent variables, although the coefficient estimates are mostly insignificant. This result is consistent with the fact that both liquidity and solvency risk in the Turkish banking sector remained at very low levels during the sample period. Low level of variation in the risk indicators is also responsible for the insignificant coefficient estimates of these variables.

Relationship banking enters into equations with negative signs as expected. The coefficient estimates are all significant at different significance levels, either 5 percent or 10 percent. Finally, *Bank age* is estimated to have positive impact on the bank revenue as expected, showing that older banks are able to attract more customers, yet *Bank age* is insignificant for the models where non-interest revenue is the dependent variable. This result is also plausible, since for non-interest revenues maturity of bank does not necessarily make any contribution. Finally, the coefficient estimate of *Bank branch* is positive in all estimations at varying levels of significance.

Table-2 presents the P-R *H*-statistics and Wald test results. In the

Table-1. Estimation results of competitive conditions for Turkish Islamic banks (2001–2013)

	FE without time dummies	FE with year dummies	FE without time dummies	FE with year dummies
Dependent Variable	Total Revenue	Total Revenue	Total Non-Interest Revenue	Total Non-Interest Revenue
PF	0.3575**	0.3569*	0.4467**	0.2975
	(3.676)	(2.720)	(3.719)	(1.575)
PL	-0.0100	0.0110	0.9005*	-0.0885
	(-0.081)	(0.206)	(2.581)	(-0.733)
PK	-0.0183	0.0823	-0.0360	0.0017
	(-0.159)	(0.659)	(-0.289)	(0.012)
PFxReform	-0.1879*	-0.0214	-0.5748	-0.3156*
	(-2.657)	(-0.133)	(-2.223)	(-2.455)
PLxReform	0.1160	-0.1623***	-1.2710**	-0.1489
	(0.551)	(-6.147)	(-3.511)	(-0.501)
PKxReform	-0.1008	-0.1763	-0.1408***	-0.2044
	(-0.565)	(-0.931)	(-10.465)	(-1.760)
Reform	-1.0307	0.3608	-1.2149	-0.5371
	(-1.569)	(0.414)	(-0.912)	(-0.999)
Liquidity Risk	-0.2863	-0.0020	-0.7332*	-0.2254
	(-1.219)	(-0.006)	(-2.535)	(-0.690)
Solvency Risk	0.5254	-1.0635	1.1817	0.8591
	(0.612)	(-0.593)	(0.271)	(0.188)
Relationship Banking	-0.6046*	-0.4251**	-0.5511*	-0.6139**
	(-3.047)	(-3.430)	(-3.002)	(-3.927)
Bank Age	1.2881**	1.6321**	0.9566	0.3133
	(3.591)	(3.248)	(0.937)	(0.299)
Bank Branch	0.5225***	0.4072**	0.6290*	0.3132*
	(8.169)	(4.748)	(2.522)	(2.382)
Year 2001				-1.2645
				(-1.226)
Year 2002		0.0738		-1.0220
		(0.799)		(-1.017)
Year 2003		0.2895		-0.3801
		(2.057)		(-0.428)
Year 2004		0.2295		0.0443
		(1.220)		(0.039)
Year 2005		-0.1437		-0.0575
		(-1.692)		(-0.074)
Year 2006		-0.3236		-0.3972
		(-0.933)		(-0.630)
Year 2007		-0.2782		-0.6130
		(-0.737)		(-1.119)
Year 2008		-0.1225		-0.4429
		(-0.331)		(-0.975)
Year 2009		-0.0961		-0.4023
		(-0.271)		(-1.022)
Year 2010		-0.1122		-0.3812
		(-0.305)		(-1.255)
Year 2011		-0.0338		-0.2673
		(-0.096)		(-1.442)
Year 2012		0.0812		-0.0809
		(0.233)		(-0.823)
Year 2013		0.0962		
		(0.301)		
Constant	3.5119	2.2247	-1.2149	7.8065
	(1.795)	(0.914)	(-0.912)	(1.177)
Observations	562	562	550	550
R-squared	0.933	0.942	0.883	0.900
Number of bankid	4	4	4	4

Robust t-statistics in parentheses
*** p<0.01, ** p<0.05, * p<0.1

first and second columns of Table-2, we find evidence that in the *pre-reform* period the sector operated under monopolistic competition when total revenue is the dependent variable in the models. The estimated values of the *H*-statistic are always highly significantly different from both zero and one at the *pre-reform* period. The finding of $0 < H < 1$ appears to be robust to different specifications regarding the inclusion of time dummies. At *post-reform* period the market structure changes to monopoly since the estimated values of the *H*-statistics are always highly significantly different from one but not from zero. The results are also robust to different specifications.

When non-interest revenue is the dependent variable in the models, the results indicate a perfect competition. The estimated value of the *H*-statistic is highly significantly different from zero but not different from one at the *pre-reform* period (test results reject $H = 0$ but cannot reject $H = 1$). Yet, at the *post-reform* period, the market condition turns out to be monopolistic competition, since estimated value of *H*-statistic is always highly significantly different from both zero and one. The results totally change when time effects are considered (fourth column). However, the results do not contradict with the basic finding of this study that is the increasing monopoly power of the Islamic banks during the sample period.

Table-2. Wald test results for P-R *H*-statistics

Pre-reform **Post-reform**	**Monopolistic competition** **Monopol**	**Monopolistic competition** **Monopol**	**Perfect competitior** **Monopolistic competetion**	**Monopol** **Monopol**
F-Statistic for testing the coefficients of factor prices ($\beta1+\beta2+\beta3= 0$)	18.99**	66.72***	11.65**	1.21
F-Statistic for testing the coefficients of factor prices ($\beta1+\beta2+\beta3=1$)	78.84***	99.49***	0.66	16.98**
F-Statistic for testing the coefficients of factor prices ($\beta1+\beta2+\beta3+\delta1+\delta2+\delta3= 0$)	1.13	0.72	14.94**	5.24
F-Statistic for testing the coefficients of factor prices ($\beta1+\beta2+\beta3+\delta1+\delta2+\delta3= 1$)	32.93**	73.07***	91.94***	53.06***

The long-run equilibrium test for the value of H is performed by using ROA as the dependent variable (see Table-3 and Table-4). In all regressions, the null hypothesis, that cannot be rejected even at the 10 percent level. Therefore, the data for Islamic banks appear to be in long-run equilibrium supporting the evidences of market condition in the Islamic banking sector.

Table-3. Estimation results of long-run equilibrium condition for Islamic banks (2001–2013)

	FE without time dummies	FE with year dummies
Dependent Variable	Return on Asset	Return on Asset
PF	0.0026	0.0032
	(0.457)	(0.432)
PL	0.0001	-0.0182***
	(0.011)	(-7.591)
PK	0.0042*	0.0048**
	(3.025)	(3.215)
PFxReform	0.0010	-0.0090
	(0.133)	(-0.964)
PLxReform	-0.0152**	0.0099
	(-3.484)	(1.516)
PKxReform	-0.0034	-0.0049
	(-2.300)	(-2.022)
Reform	0.0184	-0.0536
	(0.512)	(-1.135)
Liquidity Risk	-0.0218**	-0.0183**
	(-4.088)	(-4.909)
Solvency Risk	0.0659	0.0453
	(1.969)	(1.757)
Relationship Banking	-0.0292*	-0.0232*
	(-2.910)	(-2.619)
Bank Age	-0.0386	-0.0257
	(-1.413)	(-0.790)
Bank Branch	0.0100	0.0085
	(1.698)	(1.334)
Year 2001		0.0061
		(0.735)
Year 2002		0.0208
		(1.735)
Year 2003		0.0270
		(2.056)
Year 2004		0.0235
		(1.533)
Year 2005		0.0272*
		(2.841)
Year 2006		0.0199*
		(2.490)
Year 2007		0.0183*
		(3.093)
Year 2008		0.0176**
		(3.396)
Year 2009		0.0151**
		(4.719)
Year 2010		0.0110**
		(4.021)
Year 2011		0.0081**
		(3.402)
Year 2012		0.0095***
		(6.135)
Year 2013		0.0962
		(0.301)
Constant	3.5119	2.2247
	(1.795)	(0.914)
Observations	0.2088	0.1430
R-squared	(1.531)	(0.810)
Number of bankid	4	4

Robust t-statistics in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Table-4. Wald test results for long-run equilibrium condition

Pre-reform **Post-reform**	**Monopolistic competition** **Monopol**	**Monopolistic competition** **Monopol**
F-Statistic for testing the coefficients of factor prices ($\beta1+\beta2+\beta3= 0$)	0.87	3.34
F-Statistic for testing the coefficients of factor prices ($\beta1+\beta2+\beta3+\delta1+\delta2+\delta3= 0$)	3.28	3.69

Summary and Conclusion

This study investigated the competitive conditions in the Turkish Islamic banking sector by employing the Panzar-Rosse methodology over 2001-2013 periods. The results indicate that during 2001-2013, the market structure in the Turkish Islamic (participation) banking gains more monopolistic outlook after the introduction of various legislative and regulatory amendments. When the dependent variable is total revenue, the results suggest the existence of monopolistic competition across Islamic banks in Turkey in the *pre-reform* period. The structure, however, changes to monopoly in the *post-reform* period. When the dependent variable is changed to the non-interest revenue, the results suggest slightly different market structures yet without deviation from the basic finding of increasing monopoly power.

The findings provide evidence for an evolving market structure towards more monopoly power for the Islamic banks in Turkey which suggest a number of key recommendations concerning policies. First of all, increasing monopoly power could enable these banks to grow further in the banking system. Yet, the growth should be maintained without jeopardizing the customer welfare. For this purpose rigorous monitoring need to be done by the regulatory authorities.

Endnotes

1 See Gambacorta (2009) for the discussion about the relationship between risk-taking channel and monetary policy.

2 The discussions here are based on the overviews of principles and practices of Islamic banking and finance; see Iqbal (2001), Zaher and Hassan (2001) and Ahmad (1994).

3 The literal meaning of sukuk that emanates from the Arabic word of sakk is certificate. Sukuk quite resembles the conventional bonds. However, as opposed to the conventional bonds, which merely transfer ownership of a debt, sukuk grants the investor a share of an asset, along with the periodic cash flows.
4 The tax incentives with the amendments are as follows: (i) Any income received from the transfer of assets to and from the special purpose vehicle (SPV) is exempt from corporate taxes. (ii) Transaction parties will not pay the so-called stamp duty tax in leasing certificate transactions. (iii) The withholding tax on income decreases as the duration increases (for example a 0% tax is applied for issuances with a maturity over 5 years).
5 Although interest is strictly forbidden in Islamic banking, we try to find a baseline P-R model for the Islamic banks. Interest expenses can be assessed as the capital expenditures for the Islamic banks.

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Exploring the Demand Side Issues in Participation Banking in Turkey: Questionnaire Survey on Current Issues and Proposed Solutions

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Abstract

Since 1980s, Islamic finance has exhibited a significant growth in Turkey, whereas problems related to regulation, competition, products and the public perception of Islamic finance institutions continues to exist. This paper aims to discover the current issues and to develop solutions. In addition to our previous research, an extensive questionnaire is utilized to help mature our opinions. Questionnaires were sent to 1045 businessmen to investigate the perception of Islamic finance in Turkey. Findings indicate that problems can be classified into four main categories: problems related to the interpretation and implementation of Islamic principles and rules, problems related to competition with conventional banks, problems related to local law and regulations, and problems related to human capital and corporate governance. Possible solutions include developing a sound understanding of Islamic economics, making the Islamic supervision process more effective and transparent, easing the regulations for Islamic financial institutions to develop and implement original structures based on Islamic principles, providing fair competition opportunity with the conventional banks, promoting education programs especially in universities both to develop the theoretical framework and to provide qualified human capital to the industry.

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Keywords: *Islamic Economics, Islamic Finance, Participation Banks, Religious Businessmen*

Introduction

Since the 1980s, Turkey has gone through significant social, political and economical transformations and developments. Especially toward the end of 1980s, the rise of a new middle-rich class became obvious. The primary characteristic of this new middle-rich class has been a more pious and Anatolian identity, in contrast with Eurocentric and secular characteristic of the conventional middle-rich class of the Turkish Republic. Along with this trend, Islamic finance institutions came into existence in the form of *Special Finance Houses*. Subsequently, Islamic finance has registered a significant growth in Turkey, whereas problems related to regulation, competition, products and public perception of Islamic finance institutions continues to exist. This paper aims to discover the current issues and to develop solutions. In addition to our previous research, an extensive questionnaire is utilized to help mature our opinions. The perception and evaluation of Islamic banking in Turkey from the businessmen perspective is investigated through an elaborate survey.

The structure of the paper is as follows. Next section provides a brief review of the evolution of Islamic finance in Turkey. The survey methodology and key findings are presented, followed by a general assessment and our proposed solutions.

A Chronological Overview of Islamic Economics and Islamic Finance in Turkey

The concern with Islamic economics in Turkey began with the appearance of books and articles which had been translated into Turkish in the 1970s and became essential items in the agenda of rising political Islam. As a result of the significant liberalisation process initiated by Ozal government in 1980s, the interest-free "special finance institutions (SFI)" were introduced, among many other new structural changes in the Turkish economy.

The Turkish government, one of the founding members of the Islamic Development Bank (IDB), increased its capital share in 1984 and became one of its major shareholders. This entitled Turkey to maintain a permanent member on the board of the IDB. Consequently, Turkey has played a more effective role in the IDB that has helped realise cooperation programs among Islamic countries, supported international trade and infrastructure projects, and developed new financial instruments (Bulut and Er, 201, p. 17).

The events and processes that took place in the world and Turkey in 1990s caused the search for Islamic Economics as a distinct theoretical field to cease or to be put aside. However, as the number of SFI increased, so did their weight in the banking sector. This development may well be described as a result and cause of the rise of a class of religious businessmen. The "Anatolian capital" represented by the businessmen organizations have become a major determinant in the economic and political arena. They have been accepted as one of the building blocks of "new Turkey".

The development process of Islamic finance in Turkey can be chronologically summarized as follows:

1983: The Ozal government signed the decree of SFI that allowed the establishment of financial institutions operating in compliance with Islamic principles.

1985: The first SFI began to operate.

1985-1999: Significant growth in the sector: two new SFI were established and the market share reached 2%.

1999: These institutions were included in the new Banking Act.

2000: Banking crises in Turkey: an SFI went bankrupt along with many other conventional banks (CB).

2001: The SFI Security Fund came into effect.

2006: The SFI are transformed into "Participation Banks (PB)" and the SFI Security Fund was transferred to the Saving Deposit and Insurance Fund.

2010-2013: Four Participation Banks present with 43 billion TL asset size corresponding to 4,3% of the banking sector, 33 billion TL participation funds corresponding 5,4% and 32 billion TL loan size corresponding 6% (Yahşi, 2010).

Issuance of Sukuk and facilitating Private Pension system for PBs.

Lately, the Central Bank of Turkey, the Turkish Capital Markets Board, and the Istanbul Stock Exchange have begun to participate in or initiate some international cooperation and collaboration processes in Islamic finance.

The Survey

The Sample

Hypothetically, the vast majority of PB customers are those people who closely observe Islamic principles. Along with these two groups, a third group includes those who use only common banking services such as money transfer, bill payment, credit and debit card etc. However, this group constitutes a minority. This assumption played a major role in our sample selection process. The focus of the survey is to investigate the current status and future of Islamic finance in Turkey from the perspective of businesses that actually utilize such services.

We have followed a practical approach to reach a sample that sufficiently represents pious businessmen. We contacted five associations of businessmen of which the members consist of those businessmen who observe Islamic values and practices to a more than average degree. These associations are MÜSİAD, TUSKON, ASKON and TÜMSİAD.

MÜSİAD, short for Independent Industrialists and Businessmen's Association, founded in May 1990, is the first association among these four. It currently has 33 branches with 105 contact points in 45 countries. According to figures provided in the association's website, it has about 3,300 members producing 15% of GDP. TUSKON, short for Confederation of Businessmen and Industrialists of Turkey, was formed in 2005 by 7 different regional business federations. There are 172 businessmen association within TUSKON. ASKON, short for Anatolian Lions Businessman Association, that was founded in 1998. Its members are mainly in Istanbul but it has been trying to reach out and form branches in Anatolia, a process that has not been completed yet (www.askon.org.tr). TÜMSİAD, short for All Industrialists and Businessmen Association, founded in 2006, is the youngest among these four.

We contacted either the owners or the CEOs of the firms. The total number of participants is 1.045. However, we excluded those questionnaires with too many unanswered core questions and carried out analyses using remaining 941 observations. The composition of the participants with regard to the association is as follows: MÜSİAD 38%, TUSKON 18%, TÜMSİAD 17%, ASKON 7% and other 18%. Those participants classified within "other" category consist of those businessmen who declared themselves a subsidiary of confederation, instead of the confederation itself.

A Five-point Likert scale was used in the questionnaire. The respondents chose the agreement level they considered their own views best corresponded to, from ‘definitely agree’ to ‘definitely disagree’.

Findings

Demographics and Firm Size Profile

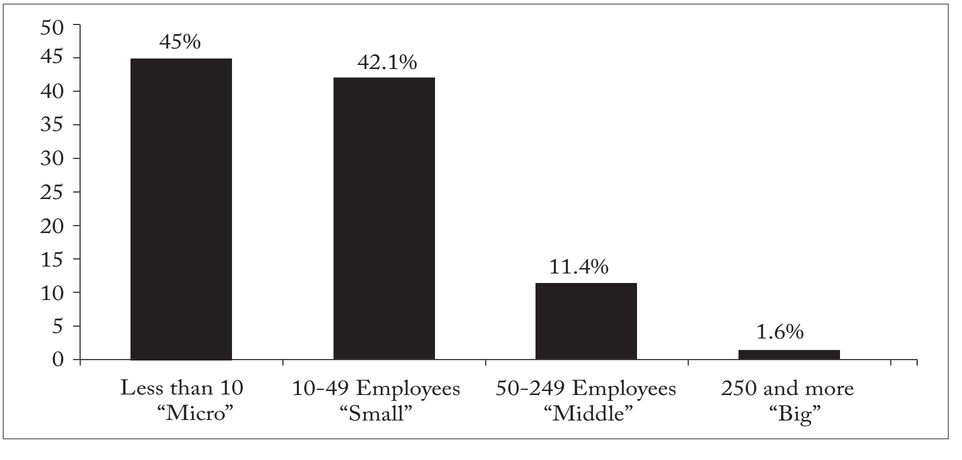
Table 1. shows the key demographic data of the participants and Figure 1 exhibits the composition of the participants with regard to firm size as measured by the number of employees.

Table 1. Key Demographics of the Participants

Education	Percent	Age	Percent	Experience	Percent
Primary School	10,2	18-30	17,7	Up to 5 yrs	13,1
High School	37,2	31-40	34,8	6-10 yrs	21,3
Vocational	10,3	41-50	35,8	11-15 yrs	19,7
Bachelors Degree	35,2	51-60	10,6	16-20 yrs	14,8
Masters and PhD	7,0	60 +	1,2	20 yrs +	31,1
Total	**100,0**	**Total**	**100,0**	**Total**	**100,0**

As can be seen from Figure 1, participants are mostly small-size firms. This result confirms the fact that the economic weight of those firms owned and managed by pious class in Turkey is still behind those owned and managed by the more secular class, despite an obvious rise in the former group over the last 20 years.

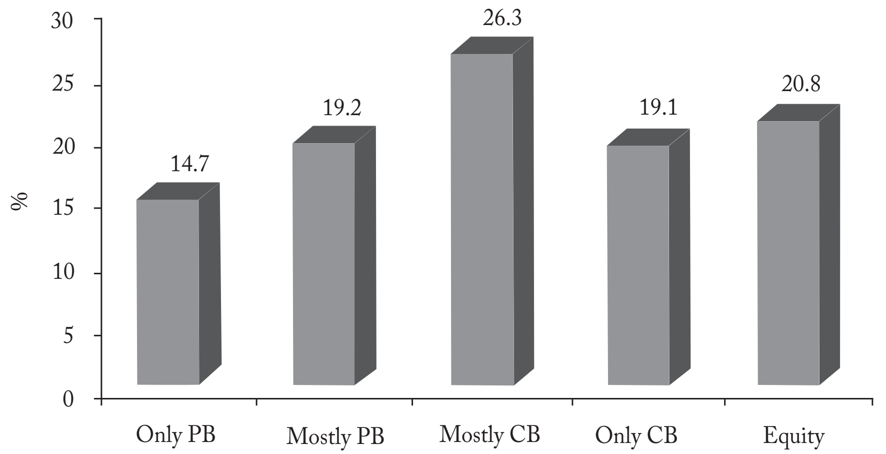
Figure 1. Composition of Participants With Regard to Firm Size



Assessment of Participation Banks

a. Financing Policy (Source of Financing): "Which of the Following Do You Prefer in Your Financing Activities?"

Figure 2. Preferences in Source of Financing



PB: Participation Banks
CB: Conventional/commercial Banks

The aggregate percentage of conventional/commercial banks (CB) (i.e., those who say "only CB" and "mostly CB") is 45, while the aggregate percentage of participation banks (PB) is 25. At first sight, it might indicate that the majority of religious businessmen prefer interest-bearing banks to finance their businesses more than participation banks. When we consider those using equity financing only (21%) together with those using only PB (15%), we see that only 36 percent of the participants never use interest-bearing financing. However, when we aggregate those using equity financing with the "only PB" and "mostly PB" group, we may have a meaningful coalition of 55% that appears distant from CB.

Note that these findings do not reflect the entire composition of the firms' liabilities on the balance sheet. In other words, these findings do not mean that the firm uses 20% equity and 80% debt financing in their operations. Participants should have perceived this question as to how they finance their "new investments only".

b. Banking Services: **"What type of banks do you prefer for banking services?"**

Figure 3. Preferences in Other Banking Services

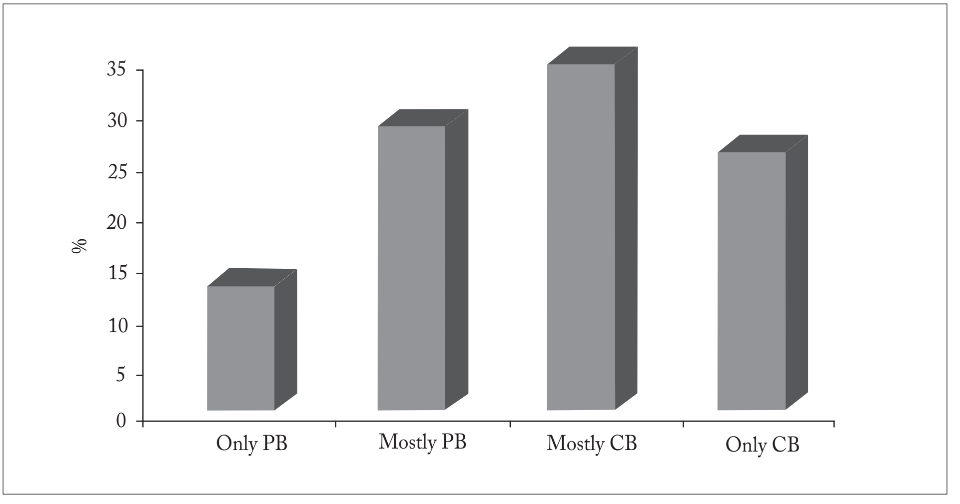
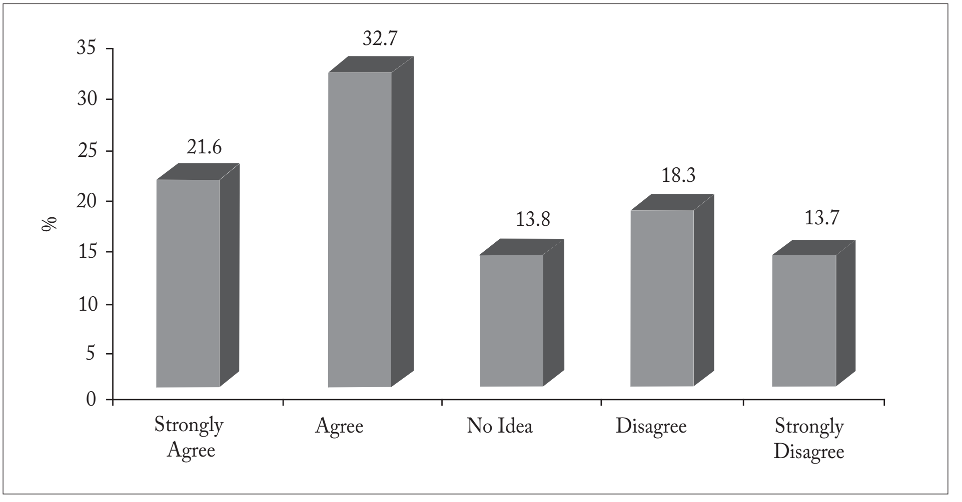


Figure 3 shows the distribution of preferences of the participants with regard to banking services other than financing, such as collections, payments, fund transfers, checking accounts, credit cards, insurance etc. The results indicate that 40 percent prefer PB while 60 percent prefer CB. The primary reason behind this result is that CB have advantages over PB in terms of widespread organization (having branches everywhere), service quality, human capital and diversification in banking products. Participants probably do not hesitate in using such services from CB as long as they do not involve interest-bearing transactions. The primary implication of this finding for PB executives might be the necessity to develop the service quality of PB.

c. The Importance of Financing Cost: **"Among Financing Alternatives, I Prefer the Less Costly Source Regardless of The Bank Type"**

Figure 4 indicates that more than half of the participants, namely, 54 percent stated that they take the cost as the only criterion in financing decisions regardless of the bank type. That is, they may well prefer interest-bearing loan of the CB if it is cheaper than financing from the PB. The proportion of those who would always prefer the PB so as to avoid interest

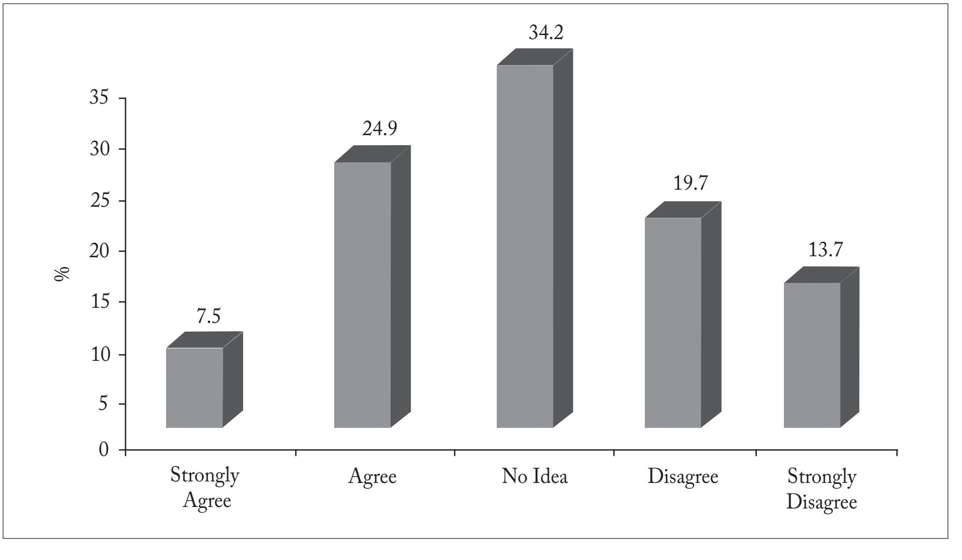
Figure 4. Considering the Cost of Financing as Only Criterion Regardless of The Bank Type



even if it is more expensive is 32 percent. This result may imply that piousness does not necessarily affect the commercial manner. In other words, it seems that a considerable portion of Turkish businessmen segregate their faith and commercial activities.

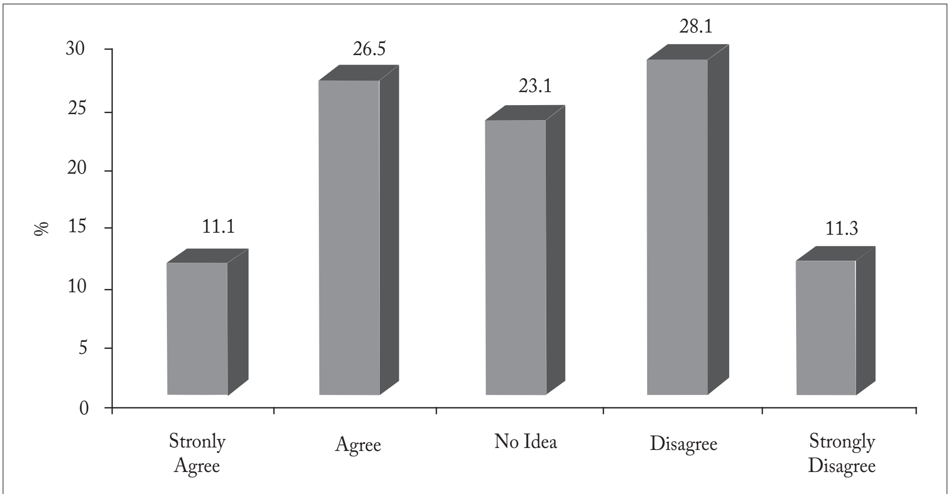
d. Are PBs Shariah-Compliant? "I Think That Participation Banks Work In Compliance With Islamic Principles"

Figure 5. Perception of the Shariah-Compliancy of PBs



e. The Difference Between PB and CB: "There is No Difference Between The Operations of PB and CB With Regard to Islamic Principles"

Figure 6. The Difference Between PB and CB



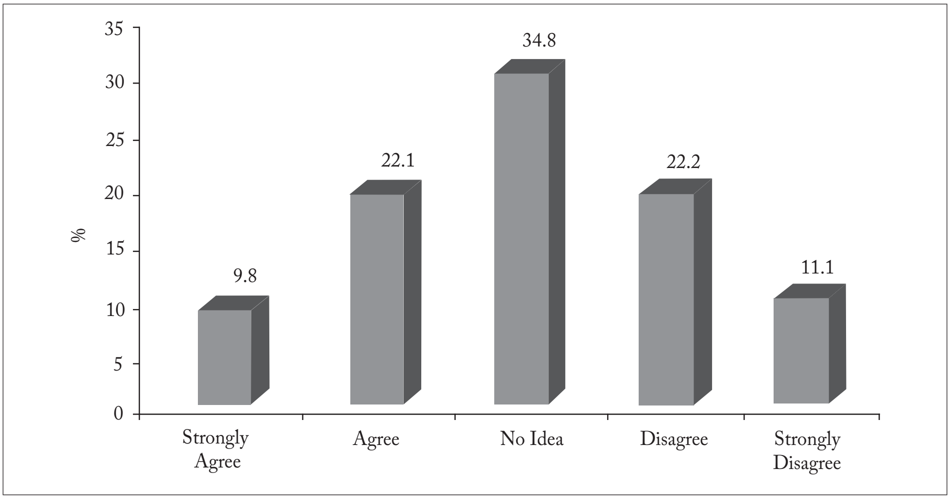
The two questions above aim to discover the same fact through reverse ways. The most striking finding in Figure 5 is the high percentage of those who have no clear idea as to whether PB work in compliance with Islamic principles and rules. The weight of those who think that PBs work in compliance with Islamic principles and rules is almost equal to those who think adversely. When the proportion of those who undecided is aggregated with total proportion of those who disagreed, it can be concluded that more than 60 percent do not believe that the PBs are Shariah-compliant. The results exhibited in Figure 6 confirm these results.

The reason behind this conclusion arise due to both absence of an effective Shariah supervision process in Islamic finance sector and lack of sufficient knowledge on Shariah within the society.

f. The Service Quality of PB: "The Service Quality of PB is Better Than That of CB "

Finally, participants are asked to assess the service quality of PB in comparison with CB. The results indicate another problem; that is one the professionals in the Islamic finance sector should consider seriously. Only

Figure 7. Comparison of PB With CB in Terms Of Service Quality



one third of the participants think that the service quality of PB are better than that of CB. The high proportion of those who have no idea indicates a lack of customer satisfaction as well. This problem is especially important because of the future prospects of the Islamic finance sector.

Analysis of Variety of Banking Choice Between Groups

This section is devoted to providing more of an insight with information provided with regard to the bank-type preference of participants. Cross tables are utilized to find out the differences between certain categories in terms of bank type preference. These categories include businessmen association, scale, education level, cost comparison attitude and belief in Islamic finance.

a. The Businessmen Associations

Cross tabulation 1, along with Figure 8 illustrating its findings, indicate that the preference of PB in financing is most among ASKON members. The sum of "only PB" and mostly PB" answers is 47%. It is followed by TUSKON with 42%, and then by MÜSİAD and TÜMSİAD with 33% each. Chi-Square test indicates that membership of one of the four organizations matter in the choice of bank at a 1 percent level. The degree in this relationship is not very strong but significant.

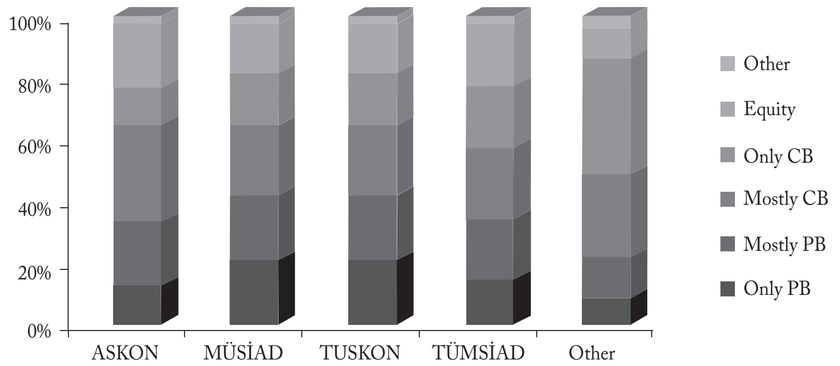
Cross Tabulation 1. Source of Financing by The Businessmen Organization Membership

		Which of the followings do you prefer in financing your firm?						
		Only PB	**Mostly PB**	**Mostly CB**	**Only CB**	**Equity**	**Other**	**Total**
Businessmen association	**ASKON**	26%	21%	18%	12%	23%	-	100%
	MÜSİAD	12%	21%	31%	12%	21%	3%	100%
	TUSKON	21%	21%	23%	17%	16%	3%	100%
	TÜMSİAD	14%	19%	23%	20%	20%	3%	100%
	Other	8%	13%	27%	38%	10%	4%	100%
Total		15%	19%	26%	19%	18%	3%	100%

PB: Participation Banks, CB: Conventional Banks

Chi-Square Value = 83.69 (Sig.= 0.000)	Contingency Coefficient = 0.291 (Sig.= 0.000)

Figure 8. Source of Financing Classified by The Businessmen Organization Membership



b. The Scale

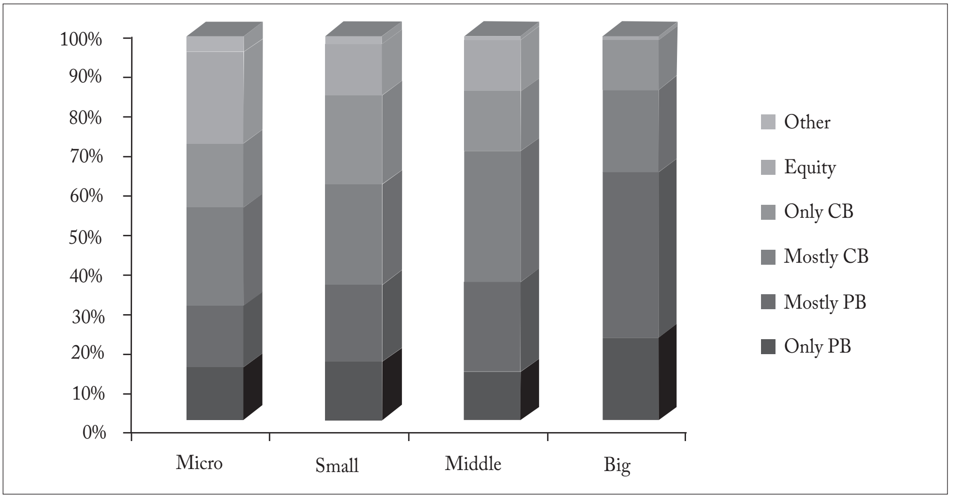
Cross Tabulation 2. Source of Financing By Firm Scale

		Which of the followings do you prefer in financing your new investments?						
		Only PB	**Mostly PB**	**Mostly CB**	**Only CB**	**Equity**	**Other**	**Total**
Firm Scale	**Micro**	14%	16%	26%	16%	24%	4%	100%
	Small	15%	20%	26%	23%	13%	2%	100%
	Middle	13%	23%	34%	16%	14%	1%	100%
	Big	21%	43%	21%	13%	1%	0%	100%
Total		15%	19%	27%	18%	18%	3%	100%

PB: Participation Banks, CB: Conventional Banks

Chi-Square Value = 37.18 (Sig.= 0.001)	Contingency Coefficient = 0.20 (Sig.= 0.001)

Figure 9. Source of Financing by Firm Scale



Cross tabulation 2 implies that the means of financing significantly differs within the size categories. Equity financing is greater in small firms. As the firm size gets bigger, use of bank funds increases. This implies that smaller firms do not have enough access to the banking system. It is quite reasonable that banks would be reluctant to work with small firms as such firms are unable to provide sufficient collateral and reliable financial statements. The shift from CB to PB is obvious only in the "big" category. The excessively small percentage of equity financing in big firms, on the other hand, should be a result of a miscommunication of the questionnaire. The result here may be interpreted as if big firms finance their entire assets with 1% equity on average, which is impossible. As noted earlier in the paper, respondents should have perceived this question as to how they finance their new investments only. The Chi-Square test verifies the existence of meaningful relationship. The contingency coefficient also indicates a significant relationship between the two variables.

c. Assessment of Participation Banks in Terms of Shariah Compliance by Groups

Here we cross tabulate bank preference attitudes against the assessment of participation banks in terms of Islamic principles. This table is expected to show how the perception/assessment of participation banks differentiates among the groups classified by financing preferences. Those

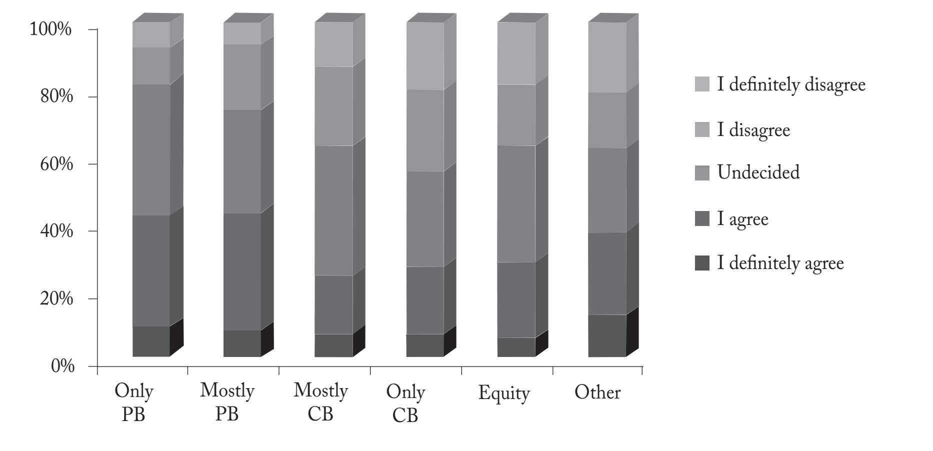
Cross Tabulation 3. Assessment on Shariah Compliance and Choice of Bank in Financing

		"I believe that participation banks operate in compliance with Islamic principles"					Total
		Definitely agree	**Agree**	**Undecided**	**Disagree**	**Definitely disagree**	
Choice of Bank in Financing	**Only PB**	9%	33%	39%	11%	7%	100%
	Mostly PB	8%	35%	31%	19%	7%	100%
	Mostly CB	7%	17%	39%	24%	13%	100%
	Only CB	7%	20%	29%	24%	20%	100%
	Equity	6%	22%	35%	18%	19%	100%
	Other	13%	25%	25%	17%	21%	100%
Total		7%	25%	34%	20%	14%	100%

PB: Participation Banks, CB: Conventional Banks

Chi-Square Value = 54.078 (Sig.= 0.000)	Contingency Coefficient = 0.236 (Sig.= 0.000)

Figure 10. Assessment on Shariah Compliance and Choice of Bank in Financing



who believe that participation banks work in accordance with Islamic principles are expected to heavily prefer PB in financing. The findings indicate that 42% of those who prefer PB (only & mostly) believe so. This is less then the hypothesized level. On the other hand, those who believe that the PB do not work in accordance with Islamic rules are expected to abstain from the banking sector and to prefer equity financing. The figures do not verifies this hypothesis as well.

The main problem with this issue is the high proportion of "undecided" groups. The "undecided" answer constitute the highest proportion in all bank preference groups. This implies that there is a lack of knowledge and consciousness regarding Islamic finance / fiqh muamalat (Islamic commercial law) among conservative businessmen in Turkey.

Conclusion

Findings indicate that problems can be classified basically into four categories: problems related to interpretation and implementation of Islamic principles and rules, problems related to competition with conventional banks, problems related to local law and regulations, and problems related to the human capital and corporate governance. Possible solutions include developing a sound understanding of the Islamic economics, making the Islamic supervision process more effective and transparent, easing the regulations for Islamic financial institutions to develop and implement original structures based on Islamic principles, having the Islamic banks adopt better governance, providing fair competition opportunity with the conventional banks, promoting education programs especially in universities both to develop the theoretical framework and to provide qualified human capital to the industry.

Finally, the ultimate success in the Islamic banking sector will not be achieved unless all stakeholders understand and internalize the very goals and principles of Islamic moral economics. As revealed by the survey, the ambiguousness and inefficiency will continue if both depositors and borrowers of participation banks do not have the same moral concern, along with the banks.

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Islamic Finance as a Means to Make Istanbul an International Financial Centre[1]

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Hasan Hüseyin Karlıoğlu**

Abstract

This paper discusses and assesses Istanbul as an international finance centre within the context of its position in the sector of Islamic finance. No doubt, Istanbul is a centre of business and culture of Turkey and the Turkish government is at present endeavouring to turn Istanbul into a regional finance centre in ten years and ,furthermore, into one of the top international financial centre in thirty years. In this context we evaluate Istanbul's potential and position to assume the role of a hub for Islamic finance. Our main conclusions are as follows; the current image, legal and regulatory infrastructure and human capacity of Istanbul do not presently allow it to become an international finance centre. In contrast, if we consider its strategic location standing between the Middle East, Eurasia and Africa as well as its strong relations with Muslim countries, and ,last but not least, its strong banking system, Istanbul has the potential to serve as a centre for Islamic finance provided that the government's ambitions remain focused in this direction.

Keywords: *Islamic Bank, Turkish Financial System,*

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Introduction and Motivation

For much of the world, the word "Istanbul" has always been a synonym for the "centre" of business, culture, and politics during a period spanning from its emergence as the seat of the Roman Empire in 330AD to the collapse of the Ottoman Empire in 1923. Over a period of 16 centuries Istanbul did not lose its status a capital and has been a key bridge between east and west as well as between north and south for almost two milennia.

There is no doubt Istanbul is the capital city of business in Turkey. Its dynamic population, standing presently at over 15m, constitutes 20% of the Turkey's population. Almost 30 per cent of economic output and 40 per cent of tax revenues of Turkey are generated in Istanbul and the city also is home to nearly 50 per cent of export-related industries. Istanbul also is a centre of cultural activity, diplomatic and international conferences. With a view to elevate the city from the position it already plays as the hub of the nation, the government of Recep Tayyip Erdogan, Turkey's Istanbul-born prime minister, has plans to make the city a regional financial centre within ten years and to transform it into one of the most important international financial centres within thirty years (IFC-Istanbul, 2009).

To make Istanbul an international financial centre is an attractive challenge. Wherever one looks, one witnesses the rapid change that has consumed the city in so varied areas as financial and legislative reform, transformations in business legislation and urban infrastructure, changes to its historic centres or alterations its coastline, Istanbul is in the throes of change. The construction of Istanbul International Financial Centre project on the Asian side of the city, that will be given the name, IFC-Istanbul encompasses the aim of creating modern offices and residential buildings alongside each other in a super-complex. The IFC-Istanbul has been envisaged to eventually house the headquarters of three state-owned banks, the Central Bank and other financial authorities. Moreover, there is a series of grand infrastructure projects such as a third bridge linking Asia and Europe and a canal to run parallel to the Bosporus Straights which divide the two sides of the city. (FT Special Report, 2010)

Istanbul has already become an international corporate hub for the likes of Coca-Cola, Microsoft, General Electric and Unilever. For instance, Microsoft selected Istanbul as the headquarters for its operations spanning 180-countries in 2000, and General Electric Healthcare chose Istanbul to control its operations encompassing 85 countries. Last but not least, the World Bank's private sector financing institution, the International Finance Corporation, opened its second biggest office outside Washington D.C in Istanbul. The International Finance Corporation directs business with 52 countries ranging from Europe to the Middle East and Africa (FT Special Report, 2011).

Istanbul has become a more and more convenient strategic location for business and more and more of an international travel hub for many international conglomerate firms who wish to operate in Eastern Europe, central Asia, Middle East, the Balkans and Africa. Turkish Airlines flies to more countries than any other airlines in the world, whereas just a generation ago there were no direct flights to even New York.

According to the Global Financial Center Index 2013 report, a city that aspires to become an international financial centre must have three key features, namely: connectivity, speciality and diversity (GFCI, 2013). Through its geographic position and airlines network capacity, Istanbul offers high-volume connectivity opportunities that serve in favour of becoming an international financial centre. For example, it is possible to fly to almost all of the capital cities in Europe, Asia, Africa via a single direct flight from Istanbul in a very short time (see Table-3). However, this is not the same case for speciality and diversity. Istanbul suffers lack of speciality and diversity in her finance sector. In this regard, this paper will focus on how "Islamic Finance" can be used as a key tool to increase Istanbul's speciality and as a lever to enhance its diversity in the finance sector on the road to becoming an International [Islamic] Financial Centre.

Many studies have found that financial improvement causes economic growth, increases employment and secures the inflow of international funds into the country (see Levine and Zervos. 1998; Calderon and Liu, 2002). In this respect, the financial sector started to play dominant and increasingly role in the economic growth of Turkey (Kansoy, 2012). However, Islamic finance has until recently played little part in Turkey financial system on account of the historically secular identity of its ruling bureaucracy and military (Ogutcu and Syed, 2013). From 2002 onwards, Turkey has undergone a fundamental shift with the emergence of the government of the Justice and Development (AK) Party. To encourage Islamic finance, new banking legislation was accepted and currently Islamic banking is accepted as a legitimate form of banking in its banking law. By enacting these changes, Istanbul has gained the potential to become a centre for international Islamic finance through the gathering of sharia-compliant funds from the region and allocating them to the rest of the world.

The rest of this study will be organised as follows; Section II reviews the existing literature. Section III provides an overview of the main features of Islamic finance. Section IV gives a historical background of Islamic finance in Turkey. Section V provides some factual features of an international financial centre. Section VI discusses the fundamental challenge facing Istanbul on the way to its becoming an international financial centre. Section VII offers concluding remarks.

Literature Review

Islamic finance is a recent phenomenon, not only in Turkey, but also in the world. For this reason, the contemporary literature of the determinations of characteristics of an International Financial Centre is still in its embryonic stage. Regarding Islamic finance in Turkey, some studies have dealt with the performance and efficiency of Islamic finance in Turkey (Cevik and Charap, 2011). Also, certain Turkish Islamic finance institutions have been included in several cross-country studies to analyse and compare systems and institutions in terms of international perspective (Beck et al. 2010; Hasan and Dridi, 2010).

Although other academic studies have investigated the potential of Istanbul to become an international financial centre (for example Sarigul, 2012; Dizkirici, 2012) and a number of newspaper and magazine articles (see Ogutcu and Syed, 2013; FT Special Report, 2012) have offered advice on the IFC-Istanbul project, no special research has analysed Islamic finance as a key element in helping the city to become a major international financial centre. Therefore, the principal motivation of this study is to fill this gap. This paper, to the best of our knowledge, will be the first investigation into the development of the Istanbul international finance centre project to look at the undertaking from the aspect of Islamic finance.

The Global Financial Centres Index (GFCI) is a bi-annual report that has assessed and ranked global financial centres in terms of different parameters such as their reputation, tax system and infrastructure from 2007 onwards. The GFCI 2013 report states that London, New York, Hong Kong and Singapore constitute the top four international financial centres in the world while Istanbul stands 57th in the list out of 79 cities. The full list can be seen from the Table 2. Furthermore, Istanbul is considered among the top ten cities likely to become more significant over the next few years (see Table 1).

Table 1. The Ten Centres Likely to Become More Significant

Cities	Number of mentions
Singapore	99
Shanghai	85
Hong Kong	68
Seoul	66
Toronto	45
Sao Paulo	32
Luxembourg	31
Istanbul	30
Beijing	27
Moscow	19

Source: GFCI-13

According to the assessment of the GFCI 2013 report, Istanbul is well supported by investors based in Middle East/Africa, Asia/Africa and North America yet has a lower reputation amongst European and Latin American investors (GFCI, 2013). Dizkirici (2012) claimed that the current position of Istanbul (as regards its international reputation) does not prove sufficient to render it an international financial centre but rather a regional one through its specialisation in the fields of interest-free financing, private equity and carbon finance. The study of Sarigul (2012) carried out a SWOT analysis of the potential of IFC-Istanbul and concluded that Istanbul has the advantage of flight-network connectivity, geographic position, a strong banking system and a young and increasingly educated and skilled labour force residing in Istanbul. Moreover, Sarigul (2012) argued that the low levels of English-language skills in the workforce, a complicated tax system and lack of specialist arbitration courts and lawyers are some of the weak points of Istanbul with regard to its ambitions to become an international financial centre.

Table 2. Global Financial Centres Index-13 Ranks and Ratings

	GFCI 13		GFCI 12		CHANGES	
CENTER	**RANK**	**RATING**	**RANK**	**RATING**	**RANK**	**RATING**
London	1	807	1	785		22
New York	2	787	2	765		22
Hong Kong	3	761	3	733		28
Singapore	4	759	4	725		34
Zurich	5	723	5	691		32
Tokyo	6	718	7	684	1	34
Geneva	7	712	9	682	2	30
Boston	8	711	11	680	3	31
Seoul	9	710	6	685	-3	25
Frankfurt	10	703	13	677	3	26
Chicago	11	698	8	683	-3	15
Toronto	12	696	10	681	-2	15
San Francisco	13	695	12	678	-1	17
Washington D.C.	14	692	14	672		20
Vancouver	15	690	16	668	1	22
Montreal	16	689	17	667	1	22
Calgary	17	688	23	647	6	41
Luxembourg	18	687	24	646	6	41
Sydney	19	686	15	670	-4	16
Vienna	20	685	36	633	16	52
Kuala Lumpur	21	681	26	644	5	37
Osaka	22	676	21	650	-1	26
Dubai	23	675	22	648	-1	27
Shanghai	24	674	19	656	-5	18
Melbourne	25	672	18	657	-7	15
Paris	26	670	29	640	3	30
Munich	27	669	25	645	-2	24
Jersey	28	668	20	654	-8	14
Oslo	29	667	33	636	4	31
Qatar	30	661	35	634	5	27
Guernsey	31	660	28	641	-3	19
Stockholm	32	657	27	642	-5	15
Riyadh	33	656	65	584	32	72
Amsterdam	34	655	31	638	-3	17
Monaco	35	654	60	597	25	57
Taipei	36	653	41	628	5	25
Milan	37	652	51	612	14	40
Shenzhen	38	650	32	637	6	13
Abu Dhabi	39	649	38	631	1	18

Rome	40	648	62	590	22	58
Cayman Islands	41	647	44	625	3	22
Wellington	42	646	30	639	12	7
Isle of Man	43	645	40	629	-3	16
Sao Paulo	44	644	48	619	4	25
Copenhagen	45	643	34	635	11	8
Brussels	46	641	47	620	1	21
British Virgin Islands	47	640	45	624	2	16
Rio de Janerio	48	639	52	608	4	31
Hamilton	49	638	46	621	-3	17
Glasgow	50	636	39	630	11	6
Madrid	51	635	50	614	1	21
Helsinki	52	634	42	627	10	7
Buenos Aires	53	633	68	578	15	55
Edinburgh	54	632	37	632	-27	0
Mexico City	55	628	55	602		26
Dublin	56	627	49	618	7	9
Istanbul	57	626	56	601	-1	25
Beijing	58	622	43	626	15	4
Bangkok	59	619	57	600	-2	1
Gibraltar	60	615	58	599	-2	16
Prague	61	611	53	604	-8	7
Johannesburg	62	610	54	603	-8	7
Warsaw	63	608	59	598	-4	10
Bahrain	64	607	61	596	-3	11
Moscow	65	606	64	585	-1	21
Mumbai	66	605	63	586	-3	19
Panama	67	597			New	New
Malta	68	595	69	575	1	20
Jakarta	69	592	71	573	2	19
Mauritius	70	590	67	579	3	11
Tallinn	71	589	66	583	5	6
Manila	72	588	73	570	1	18
Bahamas	73	587	72	572	1	15
St. Petersburg	74	585	70	574	-4	11
Cyprus	75	576			New	New
Lisbon	76	552	74	554	2	2
Reykjavik	77	546	76	539	1	7
Budapest	78	541			-3	-3
Athens	79	473			-2	10

Source: GFCI-13

Islamic Finance

Islamic banking and finance, as a main alternative to conventional counterpart, has gained an increasingly prominent presence in the international finance world. Even though Islamic finance dates back to the 15th century; the modern Islamic finance institutions emerged three decades ago and now represent one of the fastest growing asset-holding groups in global financial services. Currently, Islamic finance has spread to almost 80 countries and encompasses more than 300 institutions. Moreover, it is accepted that Islamic banking and finance has become systematically important in many countries and has a non-negligible (too big to be ignored) share on the finance industry in many countries (FT Special Report, 2010).

Even though, at first glance the Islamic banking industry seems tiny compared to the conventional banking sector, incorporating a mere 1 per cent of the international banking system, it harbours huge potential for further growth and one witnesses a growing interest in Islamic banking institutions and products in financial industry. Assets in Islamic banking increased from $ 150 billion in 1990 to over $ 1 trillion in 2012. According to the estimation of Standard & Poor's, international Islamic financial assets will grow to as much as $ 3 trillion by 2015 and $ 6 trillion by 2020 with a growth varying between 25 and 40 per cent annually for the next ten years (Ogutcu and Syed, 2013).

Using the expression "Islamic finance" does not mean that this kind of finance is merely used by strictly religious Muslims or that Islamic banks only operate in the Muslim countries. In contrast, Islamic banks and its instruments are used by both Muslim and non-Muslim customers whether in Islamic or non-Islamic world.

For instance, Malaysia is a country with only about a 60 per cent Muslim population that has a long tradition of Islamic banking, in a state in which almost 50% of clients of Islamic financial institutions are in fact non-Muslims. Furthermore, even in a country where Islamic banking is still at its rudimentary level, such as the United Kingdom, many non-Muslim investors in London accept Islamic finance as a way to diversify portfolios particularly in the context of the financial turmoil provoked by the recent financial crises in the Eurozone (Aldohni, 2011).

Outside Europe, China is increasingly looking at Islamic banking finance as a different method of investment. China has granted its first

Islamic- banking licence and a number of important banks are reported to be considering how they can create Sharia-compliant financial instruments. Singapore has modified laws to create a market in Islamic property investment trusts. Furthermore, Australia is also hinting at legal reforms to encourage Sukuk- Islamic bond- issuance (FT Special Report, 2010).

Islamic Banking in Turkey

Turgut Ozal, the Prime Minister, started the economic transformation from a tightly state-controlled economy to an open-market based economy during 1980s. Thanks to these years of reform, there emerged real efforts to attract national saving into the real economy and more foreign direct investment from Muslims Countries and Islamic Banks were permitted by government decree to operate in 1983 under the name of "Special Finance Houses" without any direct reference to "Islam" or any "religion- based terms".

Albaraka-Turk was the first participant in the sector in 1984, by Faisal Financ, established in 1985. Another prominent player, Kuveyt-Turk, a Gulf oriented bank, entered the sector in 1998. The number of special finance houses remained at three till 1991. In 1991 the first fully domestic capital-focused special finance house, namely Anadolu Finance (afterwards Anadolu Finance its name to Turkiye Finance), started business in the sector. Ihlas Finance began operations in 1995. Lastly Asya Finance joined the sector in 1996.

On one hand, the Islamic banks or "Special Finance Houses" were highly regulated by a secular and therefore sceptical bureaucracy; on the other hand, they did not enjoy the same status as their conventional counterparts. For instance, Special Finance The houses were not covered by the Central Bank's insurance scheme and they were also not allowed to invest in government securities.

Banking Law No.5411 officially replaced the ambiguous term "Special Finance House" with the moniker "participation bank" in 2006. As a result of this fundamental change, Islamic banks or 'participation banks' began to be accepted as real "banks" like their conventional counterparts. Also changes in the title and the status of Islamic banks increased the recognisability of Islamic banking institutions in the international finance world. Currently, both Islamic banks and conventional banks operate according to the same laws and there are four participation banks in Turkey presently operating.

These changes can be interpreted as a shifting paradigm in the level of tolerance and acceptance for Islamic banking in Turkey. The position of the Islamic banking system has been strengthened with new legislation that allows Sukuk, Islamic bonds, and a Halal Index a presence at the Istanbul Stock Exchange. The Central Bank of Turkey guarantees all of these innovations. Up to this moment in time, the Halal Index has not yet come into operation.

Conventional banks currently own a lion share of the banking sector in Turkey and interest-free banking remains a small part of the sector. This state of affairs will probably continue so due to lack of penetration in the market through tough competition from the conventional banking system unless the government takes action in favour of Islamic banks.

Istanbul as an International Islamic Finance Centre: Discussion and Advices

In present literature, there are many different definitions of an international financial centre. In short, an international financial centre is a city that provides customers with an environment for meeting, receiving and conduction financial services that is international in scale and outlook and is independent of limiting factors of its host country. Generally, the major features of an international financial centre are; the *business environment, people, taxation, reputation, infrastructure and market access.* The *business environment* means that the city has a high quality of rule of law, a low rate of corruption and a high rate of trust among clients. The term *People* represents the increasingly educated, high quality and skilled labour force employed in the field of finance industry. The parameter of *Taxation* indicates that the city that wishes to become an international financial centre should have a simple and stable tax system. *Reputation* signifies that the city must have a high reputation amongst national and international clients and investors. *Infrastructure* means that high-quality and fast telecommunication and IT facilities should be provided by the home country at a low cost. *Market Access* highlights that the city should be well-connected to other regional and international financial centres. Also, in terms of geographical perspective the city should be able to easily access many growing markets.

According to these benchmarks, London, New York, Hong Kong, Singapore and Zurich currently constitute the top five financial centres. Thanks to the quantity of distinguished and complex financial products and the great number of transactions operated, it is not possible to compare the other financial centres with London and New York. Rather than London and New York, most financial centres focus on some special sectors of the economy and geographical regions that might present them with a comparative advantage. For example, Hong Kong has emerged as a regional financial centre by focusing on the supply of financial services in the Asia-Pacific region for several decades. Currently, Hong Kong is known as a centre of syndicated loans for its region. Singapore has become a finance centre for low-cost management, marketing and R&D services and manufacture sector in the region. Other examples can be mentioned. For instance, for investment banking the right address is Luxembourg while Zurich enjoys a comparative advantage for private banking, Brussels is a centre for legal affairs such as arbitrage. Lastly, Dublin is accepted as a back office of the finance sector thanks to the advantage of technological infrastructure.

Therefore, it follows that Istanbul should specialize in some specific areas of the economy as the other regional financial centres mentioned above have done. The striking potential and position of Istanbul such as its prominence in the flight network (see table 3), its qualified and skilled labour force, its strategic geographical location between Eurasia, the Middle East and Africa render Istanbul able to play the significant role of a regional hub for Islamic economic enterprise (see table 4).

Table 3. Flights Distance and Times From Istanbul to Other Financial Centres

City	Flight Distance	Time (hour)
Bahrain	1700	4
Dublin	1600	4.25
London	1400	4
Moscow	1000	3
New York	4500	11
Paris	1300	3.5
Tokyo	5300	11.5
Warsaw	850	2.5
Zurich	1000	3

Source: The Banks Association of Turkey Report, 2009

Furthermore, its economic, social and demographic structure, developed financial markets, distinguished financial institutions and instruments are the cooperative advantages features of Istanbul that potentially allow it to become a centre of Islamic Finance in the region. Moreover, according to Ozsoy and Yabanli (2010), the Islamic banking system of Turkey is one of the most developed in the world in terms of laws, regulations and banking.

Table 4. Top Ranked Cities in the International Financial Services City In Islamic Finance

Rank	City	Total connectivity	Site service status	No. Head offices
1	Manama	1	23	15
2	Tehran	0.84	14	12
3	London	0.78	13	2
4	Dubai	0.68	12	5
5	Amman	0.45	5	2
6	Beirut	0.44	6	1
7	Paris	0.42	5	0
8	Istanbul	0.38	6	3
9	Abu Dhabi	0.36	3	1
10	Cairo	0.35	4	2
11	Tunis	0.34	5	1
12	Kuala Lumpur	0.32	10	10
13	Alger	0.26	4	1
14	Baghdad	0.26	2	0
15	Jeddah	0.23	4	2
16	Al Ain	0.22	2	0
17	Karachi	0.22	10	6
18	Muscat	0.22	2	0
19	Ras-Al-Khaimah	0.22	2	0
20	New York	0.21	2	0

Source: Bassens et al. 2009

Issues to be Addressed for an Islamic Financial Centre

There are some principal features that must exist in every city that desires to become an international or a regional financial centre.

Image and Perception

A good “image” or “perception” of the investor with regard to the city has a crucial role in attracting finance corporations. The first step that must be taken is changing the current constitution that was adopted 1982 after military coup. Naturally, the current constitution remains far from international standards in terms of liberality, flexibility and diversity. Hence, it is likely to create a negative impact on personal and collective images of Turkey internationally. For example, according to the Economist Intelligence Unit's 2012 democracy index, Turkey is ranked 88th out of 169 countries. Turkey was also ranked 33rd out of 50 countries assessed in the Anholt National Brand Index that surveys consumers from around the world on their 'brand perceptions' of countries in 2011. Therefore, the initial strategy must be to rapidly and effectively promote the image of Istanbul as a financial centre by identifying the target audience, especially in Middle Eastern and Gulf countries, and determining the weak points of the current perception. After taking these steps, an effective promotion strategy should be determined. Another important point to consider is that there is no single Sharia Supervisory Board, namely a single main organ able to assess, approve , contract, document and supervise all transactions of Islamic banks in parallel with principle of Islamic law. The lack of an overseeing authority varies with regard to he participation banks (Aldohni, 2011).

The board is allowed to cancel, change or terminate any operations that contradict Islamic law according to their interpretation. Such potential differences on the Sharia Supervisory Board do not allow the emergence and continuation of effective corporate governance in the Islamic banking industry in Turkey. For example, incoherent decisions made by the Board in different Islamic Banks would create the loss of consumer confidence in Islamic banks and so lead to potential systematic failure. If the decisions of different Sharia Board were to contradict each other, the lack of coordination would most likely lead to a sudden withdrawal of deposits from Islamic banks.

Such reactions may be dissimilar from those present in conventional banking that are motivated largely by the fear of customers of simply losing their money. Rather, the main reason for withdrawal of deposits may be Islamic sensitiveness in this context. The depositors may think thank their investment is used in non-Islamic operations; that in fact represents the principal factor that they preferred not to use conventional banks. In other words, when the Islamic character of the bank is called into question, the Islamic banking sector may lose its validity and confidence. For these reasons, there should be a common authority to assess and regulate Islamic banking operations. Also, the creation of an institution that standardizes and increases the validity of the sector may help to bring international Islamic funds into the Islamic banking sector in Turkey.

Human Resources

Malaysia, a relatively small country of about 30million people of whom 60% are Muslim, has registered great achievements in the field of Islamic finance. According to The Economist (2013), Malaysia dominates the global Sukuk, that is the Islamic bond market with responsibility for approximately 75% of total international Sukuk. By creating a centre for training the leadership in international Islamic banking and finance rendered it able to register such successes in the field of international Islamic economic activity. The International Centre for Education in Islamic Finance, INCIEF, was established in 2005 by the Central Bank in order to provide highly qualified and educated people for the Islamic banking sector and so far almost 2000 students from 80 different countries have graduated from this school. There also exists a Sharia Research Academy to produce and determine the international standards of Islamic banking. All of these have ensured the dominant status of Malaysia in Islamic finance (The Economist, 2013).

However, there is no government policy or action plan to deal with the weak relationship between the [Islamic] finance sector and universities. To date, there were no post-graduate programs that specialise in Islamic finance to an international standard. Turkey has a considerable number of high quality education institutions and academics as well as a young and increasingly educated dynamic human capital. Therefore, there needs to be a consortium established consisting of the Ministry of Education, the Higher Education Council, the Turkish Banking Association, the Participatory Banks Association of Turkey, the Central Bank, the Banking Regulation and Supervision Agency, the Capital Market Board and a number of prestigious Universities to set up a post-graduate level school similar to that at London School of Economics, Paris School of Economics, INCIEF to provide an international level education with a specialisation in [Islamic] finance and banking. Hence, the name of school might be Istanbul School of Economics in order to take advantage of the 'brand name' of Istanbul.

Legal Framework

Regarding the tax system, the general perceptions with reference to the banking and finance sector in Turkey are quite sceptical as to whether the current tax system has the potentioal to turn Istanbul into an attractive centre in the region for Islamic investment. The current tax system in Turkey is far from being a simple, transparent, effective, sustainable, predictable and applicable one. Due to the frequent changes in tax law, feelings of uncertainty have risen and the tax mortality has decreased. As a result, the tax system needs a massive tax adjustment to attract foreign Islamic capital. It also requires radical reform to eradicate comparative disadvantages on the road to becoming international [Islamic] finance centre for Turkey. The reforms must target tax incentives to enable Islamic finance to realise its potential to become a key financial sector in Turkey in the near future.

Probably the weakest point of Istanbul in its endeavours to become an international [Islamic] financial center is the absence of specialised courts and qualified judges, lawyers able to serve within the international financial center framework. According to report of the Turkish Banking Association, only 50-100 legal professionals, out of about 60.000 professionals, are able to serve within an international financial framework and furthermore, only a limited number of legal professionals are aware of few people aware what Islamic finance actually constitutes, so as to solve a problem within the context of Islamic law. Therefore, the government needs to set up new specialized courts that are experts in financial disputes concerning Islamic financial practices.

Regulation and Standardisation

Due to an increasingly globalised world, there have emerged many different types of economic crises, and the financial industry and related institutions have been forced to change rapidly. For that reason a well-founded regulatory and supervisory system must prove itself flexible to respond to the mentioned changes.

In the context of becoming an international Islamic financial centre, there is lack of harmonisation with other international Islamic norms. For example the confusion of recent new regulations that allow investment in Islamic finance instruments including *Murabaha, Mudaraba, Istisna, Musharaka* and *Sukuk,* but which force different names in official statements such as the name of a given participation bank, which is known as an Islamic bank in the rest of the world except Turkey because of secular identity. To attract more funding, especially from the Middle East, Gulf and both other Muslim and Non-Muslim countries, the Turkish government authorities should reinforce an effective and sustainable coordination between regulatory and supervisory authorities and harmonise its Islamic finance framework on an international level. Last but not least, in order to increase the competition and validity of the sector the government should enter the Islamic finance centre in Turkey.

Conclusions

Both the development Islamic finance and the efforts to become an international financial centre in Turkey have been recent phenomena that have attracted great attention. The secular identity of state and military consistently and routinely resisted the Islamic influence on the business and finance sectors. For that reason, up to just a decade ago it was almost unimaginable that a government would be able to issue Sukuk, Islamic bonds, since it was believed that such activities may destroy Turkey's strong secular identity. Through the fundamental change in approach to politics by Erdogan's Government the Islamic banking sector has grown year by year the share of Islamic banks has increased from 2 per cent to 6 per cent as regards total banking assets over the last ten years. Also, the trust in conventional banking sector has fallen due to recent financial crises in 2001 and 2009. As one of the plans to celebrate the 100th anniversary of the modern Turkey in 2023, the government targets to turn Istanbul into an international financial centre. In this regard, they are planning to invest $350 billion in infrastructure and carry out many different types of reform and regulation with respect to the realisation of the international finance centre project.

As part of the effort to make Turkey a regionally important centre, in the short term, the government wishes to see Istanbul become an international Islamic financial centre. Historically and geographically Istanbul has always been a key link between east and west as well as north and south for centuries. Istanbul was technically ready to be an international Islamic finance centre ten years ago however did not want to be take part in Islamic finance because of its secular sensitiveness. For that reason, it was questioned whether Istanbul had already left it too late to catch up with other financial centres such as Kuala Lumpur. Nevertheless, the government and the Islamic banking sector in Turkey are optimistic with regard to Istanbul's long term objective to achieve its goal and aim to contribute to its legal and regulatory environment, human resources, image, and infrastructure.

Istanbul still has a long way to go to create an Islamic financial centre. For example, regarding the legal environment, the government must increase the efficiency of courts, establish new specialised courts that concentrate Islamic finance disputes and Turkey also needs to have a stable, transparent and predictable tax system. Moreover, the coordination and cooperation between regulators and market participants must be enhanced. To compete with other financial centres Istanbul has to improve its image regarding Islamic financial services. The government has already identified these issues and others not mentioned here in its 2009 plan. However, these have not been addressed fully and ,as a natural result, Istanbul still has a long way to realise its dream.

Endnotes

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Is Development Accumulation of Wealth? Islamic Views

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Abstract

The idea that development is mainly about the accumulation of wealth commands widespread support. Dissenters have introduced other dimensions of development, but nonetheless agree on the centrality and importance of wealth. However, Islam is primarily concerned with spiritual and moral development. Teachings of Islam created an inner revolution within the companions of the prophet, which led to the creation of a new form of society with distinctive institutions and ideology. Eclipse of Islamic civilization, and the rise to global dominance of capitalist societies has led to widespread acceptance, even among Muslims, of ideas antithetical to Islam. In this article, we expose and refute one dozen widely believed myths created to support Western hegemony, and provide alternative points of view.

Paradigm Shifts

For the majority of readers, this article will present ideas directly in conflict with their core beliefs. This is because core beliefs of the dominant Western civilization have spread far and wide via educational systems as well as ever expanding nets of media. Many of these western core beliefs are in direct conflict with Islamic ideas, but the conflicts are not apparent to most Muslims. A collection of core beliefs, or a paradigm, is the framework we use to understand the world we live in. This means that core beliefs are not really open to discussion or even visible – they are buried within the foundations of our thought processes about the real world. Standard

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methods of logic and argumentation, compiling of evidence, etc. are not effective in changing core beliefs. This is because core beliefs are a coherent collection of inter-related ideas which are fundamental to the way we look at the world around. When we encounter data or evidence against a core belief, then a large variety of "insulating" strategies are used to prevent us from having to change the core belief. Occasionally, a huge amount of compelling evidence can force a change in a core belief. This creates a "revolution" because we cannot simply change a core belief – we have to re-adjust the entire collection of core beliefs and change the framework we use for understanding the world. In a sense to be explained further below, the world we live in changes when our core beliefs change.

It is our contention that Islam brought about a revolution in knowledge that changed the course of human lives forever. The first lines of the Quran revealed to the Prophet Mohammad S.A.W. are powerfully infused with the importance of knowledge:

96:1-5 Read: In the name of thy Lord who createth; Createth man from a clot. Read: And thy Lord is the Most Bounteous, Who teacheth by the pen; Teacheth man that which he knew not.

The very first command of the Lord of Creation is to READ, and the very first bounty mentioned is to teach man that which he knows not. It is this knowledge that transformed the lives of those who absorbed the message of Islam, and created a revolution in the world. Today that knowledge has been lost, even by the Muslims – it was prophesied that Islam came as a stranger, and will become a stranger. To understand this claim, one must differentiate between theoretical knowledge and applied knowledge. This is the difference between reading a book on surgery, and actually performing surgery or driving. The theoretical knowledge of Islam is perfectly preserved, as was promised to us by Allah. The practical knowledge is promised to us conditional on our struggle to realize these teachings in our lives and in the world around us (just as surgery is learnt by experience). Today the Muslims are struggling for diverse ends, but few are engaged in the struggle to spread the good and to prohibit the evil that surrounds us. One of the obstacles is that the goals and methodology of this struggle for justice have become obscured by the spread of a large number of false ideas, which have become deeply rooted. This article highlights these ideas (myths) and opposes them by alternatives (truths). It is my hope that this will serve as a necessary preliminary step to understanding and appreciating the deep insights the Islam has to offer about the human condition, and how to improve it. According to current widely accepted western ideas, Islamic knowledge is normative, and hence not really knowledge at all.

Before proceeding, it is necessary to clarify further why paradigm shifts cannot be achieved by standard processes of rational arguments and debate. Consider a paradigm as a collection of interlinked and coherent ideas A, B, C, D, and E. Consider an alternative paradigm based on an alternative collection of ideas V, W, X, Y and Z. All data and observations can be explained by both paradigms, although each may have different areas of strength and weakness. This is the defining characteristic of a paradigm, that it forms a framework for the interpretation of the entirety of the real world around us. So it will not be the case that we can find a fact which affirms one paradigm and contradicts the other. All facts can be explained by both. Similarly the standard step by step learning process fails to work to achieve paradigm shifts. To explain why, think of a paradigm as a cluster of coherent beliefs all of which support each other. Call this cluster A, B, C, D, and E. An alternative paradigm is an alternative cluster V, W, X, Y and Z. Taken individually, each of the elements of the alternative VWXYZ conflict with the original paradigm ABCDE. Thus a person who believes ABCDE will reject each element V, W, X, Y and Z because every single one of them will seem wrong. He will not be able to see that if he abandons his own paradigm, and considers the whole structure VWXYZ together, it forms a coherent whole.

There are two ways to see this cubical picture. One cannot make logical arguments as to which is the "right" way of seeing the picture. So how can we achieve the paradigm shift that we are hoping for? In order to be able to comprehend an alternative paradigm, one must let go of all of the original core beliefs at the same time – since we interpret the world using our core beliefs, none of the alternative core beliefs make sense if we try to interpret them within our existing framework for understanding the world. This is an act which requires courage, since giving up core beliefs amounts to destroying (our understanding of) the world we live in. It also require hope and trust, since we will abandon our worldview only if we hope for something better, and we trust the source of information for the alternative (since we cannot evaluate it evidentially).

This article is addressed to Muslims only for this reason. Muslims have already absorbed the fundamentals of an alternative worldview through the teachings of Islam. They trust the Quran and Hadeeth, and have faith that Islamic teachings are superior to all worldly knowledge. Typically, their education gives them a dual perspective, with some modern and some religious elements. It is possible for them to contemplate the possibility that the fundamentals of the modern world view are wrong – they can jump to the Islamic worldview for safety. A secular audience does not have an option. Abandoning the modernist worldview would leave them with no place to stand, and so they must attempt to reconcile conflicts within the modernist frameworks available, none of which provide any basis for answers to certain crucial questions which we face as human beings.

Idealism Versus Materialism

There are two different approaches to understanding the world we live in. One is a materialist approach, which pays substantially more attention to the concrete realities of the world around us. In contrast, the idealist approach focuses more on our ideas about this world around us. This second approach emphasizes human beings over material circumstances. Materialism is the dominant philosophy in current times. This philosophy creates the biggest obstacles to understanding what development is and how it can be achieved. By focusing only on the material causes of development, it point towards harmful remedies. Our contention, very surprising to materialists, is that wrong ideas about development are the greatest obstacle to devising and implementing correct plans for development. In this section, we start with three fundamental wrong ideas associated with a materialist perspective.

Myth #1: Materialistic Determinism

Materialism is a philosophy which gives primacy to material circumstances as determinants of history. That means that the fate of nations is determined by material circumstances – if they have good geographic location, natural resources, and other favorable materials, then they will progress. Lack of development is explained by inadequacy of natural resources. On this view, nations are undeveloped because they lack material resources. There are two ways to overcome this problem. One is to increase the savings rate within the nation, and the other is via foreign aid.

Both of these are methods which have been strongly recommended and utilized by economists in the twentieth century. Both have failed miserably to produce good results.

For example, Mahbubul-Haq was an enthusiastic proponent of the first strategy in Pakistan. Mahbubul-Haq recognized the short run harmful effects of the increased savings strategy for growth:

"It is well to recognize that economic growth is a brutal, sordid process. There are no short cuts to it. The essence of it lies in making the labourer produce more than he is allowed to consume for his immediate needs, and to reinvest the surplus thus obtained."

Bari (2011) provides the citation above and also shows how experience led Mahbubul-Haq to a complete reversal of views. In the recent past, Sachs (2006) has been an enthusiastic proponent of the second approach, namely foreign aid. Easterly (2001) has provided a sharp critique, showing how this approach has been a gigantic failure in the past, and is unlikely to produce the desired results in the future.

Another easy way to see that the idea of material determinism is wrong is the following. It can be checked that in terms of material resources, USA, Russia, Brazil and India were roughly on par in the early nineteenth century. Yet all four have had drastically different development trajectories. If the theory of material determinism was even roughly correct, then this should not have been the case.

Truth #1: Visions and Ideas are Powerful

The history of mankind is the history of visionaries and idealists, men committed to grand ideas who gave their all and changed the course of history. The greatest example for us is our Prophet Mohammad S.A.W. who took the Arabs from the bottom to the top fourteen centuries ago. At the time, the Arabs were primitive and illiterate nomads in a world which had advanced civilizations like Roman, Persian, Egyptian and Chinese. Historians like Hart (2000) have correctly identified our Prophet Mohammad S.A.W. as the single most influential person in human history. His life changed the course of human history forever, and his work has deeply influenced the lives of more than a billion people on the planet today, fourteen centuries after his passing. What material changes did the Prophet bring about which created this revolution? The answer is NONE.

He did not introduce new weapons, techniques of warfare, or any new industry or technology. He gave a new vision to the Arabs, in the shape of Islam, and this vision re-shaped the world.

Throughout history, it has been men of vision who have brought about the greatest changes, unconstrained by material resources. Karl Marx was dismayed by the exploitation of laborers by capitalist as a result of the industrial revolution in England. His vision of an egalitarian world where each would be provided for according to their needs captured the imaginations of many. It changed the course of history in Russia and China; no material means were involved. It is ironic that Marx himself was one of the greatest advocates of material determinism, since the impact of his ideas furnishes such a strong counterexample to his own theories in this regard. In a similar way, it has always been leaders with visions which have, for better or worse, changed the development trajectories of their nations.

It is important to clarify that ideas by themselves *cannot* directly impact the real world – they must *always* be translated and implemented via material means. This means that there will always be an apparent material cause, which allows us to ignore the vision and idea behind the material cause. For example, materialists might argue that the atom bomb led to the US victory over Japan. This ignores the ideas which led to the conception of the atom bomb, as well as the ideas which made it morally permissible to kill millions of innocent civilians as a demonstration of power.

Lesson #1: De-colonizing the Mind

If material circumstance will not determine our development trajectory, then what will? My main contention in this article is that the greatest obstacle to development is the vast number of wrong ideas which we have absorbed due to a western education. Removing these blindfolds from our heads will enable us to clearly see the pathways to progress. This must be the first step, though certainly it will not be enough by itself. It is essential to see the goal clearly, before one can take steps towards achieving it. In particular, development will not be achieved by any of the popular nostrums – such as privatization, liberalization, good governance, democracy etc. – being touted as the remedy for our ills. Another important consequence of unlearning material determinism is the importance of people. Human beings like you and I have changed the course of history by learning new and powerful ideas. Thus our ignorance is responsible for current conditions prevailing on the planet, and knowledge will guide us to the efforts required to change them. The understanding that we can change things is one of the most powerful ideas that is required to make changes. The oft-expressed despair that we are locked into a bad condition, and there is nothing we can do to change things, is a powerful obstacle to progress.

Myth #2: The World is built of Stones, Mountains and Rivers

The materialist world view tells us that we live in a world constructed out of mountains, rivers, oceans and continents. There are physical laws which bind every particle to a determinate trajectory. These are concrete hard realities, written in stone, which constrain the scope of our possible actions. As individuals, we have very little power to change things. An individual weighing 80 Kilograms cannot make much of a dent in a world massing thousands of metric tons.

While no one can deny the existence of the world out there, it is also true that we all have a picture of this world in our own minds. This picture is a very rough approximation of the true reality out there. When we think about the world, we have no access to the "true reality" – we only have access to the mental representation of this reality within our minds. Nearly all the furniture in my mental landscape -- Hiroshima, Africa, the Mongols, the Steam Engine, Red Indians, Baghdad – consists of accounts that I have read and absorbed, rather than experienced reality. Our lives and actions are far more strongly influenced by this mental representation of the world, than by the real world.

The materialist world view is based on the idea that the mental representation of reality is a close and accurate match to the true reality. Or, if it is not a close match, then it ought to be. If there is no close correspondence between the real world and our mental model of it, then our mental model is flawed. We must fix the model to bring it into correspondence. This means that there is only one good mental model of reality, and that is the actual reality, which is unique, fixed, and the same for all. These widely believed materialist ideas de-emphasize the role of the mental models that we have of the world we live in. They also lead us to believe that it is only the hard and fixed concrete reality out there which matters.

For every collection of facts, there are a large number of theories which fit all available facts. That is, the collection of facts does not uniquely determine a single valid theory. This is called “under-determination” and has been discussed in great detail by Salim Rashid (2009). Thus we always have available to us different theories which will fit all available facts. Thus we have substantial amounts of freedom in creating a representation of the world which is faithful to all available facts.

As Keynes (1936, p. 383) said:

> “The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.”

We have a large number of ideas about the world we live in. We are used to thinking in binaries – this idea is true and that one is false. We also believe that there is only one set of true ideas which describes accurately the world we live in. A collection of ideas which shapes the world we live in may be called a worldview. There are many alternative worldviews possible, all of which provide explanations of the facts we see. We have a free choice among worldviews, which is not constrained by facts. Choice among worldviews must be made on other grounds. Believing that there is only one possible view which is factual, objective and concrete leaves us in ignorance of other frameworks and worldviews. When we are not aware of the extremely important choice of how to organize the world we see into a coherent and understandable reality, then this choice is imposed upon us by others. That is, without any conscious awareness of having made a choice, we accept a worldview implicit in the ways that the world is described to us by others. In support of these ideas, Eribon (1992, p. 282) quotes Foucault:

> There are more ideas on earth than intellectuals imagine. And these ideas are more active, stronger, more resistant, more passionate than “politicians” think. We have to be there at the birth of ideas, the bursting outward of their force: not in books expressing them, but in events manifesting this force, in struggles carried on around ideas, for or against them. Ideas do not rule the world. But it is because the world has ideas (and because it constantly produces them) that it is not passively ruled by those who are its leaders or those who would like to teach it, once and for all, what it must think.

Truth #2: The World is Shaped by Human Choices

In opposition to the materialist view, we would like to argue that the mental representation of the world we live in is extremely important. The world out there is not "knowable". The geography and history of this world is far too rich and complex to be grasped by any mind. This means that the materialist ideal of a perfectly accurate model of reality is impossible to achieve. This corresponds to the Quran [17:85]: "And of knowledge, you (mankind) have been given only a little." Our experience of the world we live in will be strongly influenced both by the small number of facts that we know, and also by the large number of facts that we never learned during our lives. This places tremendous premium on learning the important facts, since we can never know all of them. But how can we learn what is important, and what is not, without knowing all of them? This is the dilemma of human knowledge.

Our mental models of the world, and our normative conceptions of the good and the bad determine the choices we make in the course of our lives. Our lives are far more deeply affected by the collection of human choices than by the material forces around us. It is stated in a Hadeeth that Allah T'aala creates circumstances in response to human actions – if we make good decisions, then good outcomes results. The Quran (30:41) (see also 42:30) shows that bad actions lead to bad outcomes:

30:41 corruption has appeared on land and in the sea as an outcome of what men's hands have wrought

Our ideas about the meaning and purpose of life, as well as appropriate strategies for achieving these goals influence our actions. A huge portion of the world we live in is constructed by social conventions – human ideas about how we should live which command consensus of large communities. For example, we live in Pakistan. Pakistan is an imagined community; it does not exist, except in the minds of men. Suppose that we could achieve consensus tomorrow that nations should not exist, and that mankind should live in harmony and peace with no artificial national boundaries. Then nations would cease to exist tomorrow. The mental representation of the world does not consist purely of rocks and stones which are concrete and unchangeable. It also consists of powerful ideas, which have acquired concreteness and substance through our consensus and acceptance. Changing our mental models can change the world we live in.

Imagine a world in which all human beings are kind, considerate, compassionate, truthful, responsible, and have the characteristics described as good in the Quran. Alternatively imagine a world in which people are selfish, competitive, ruthless, power hungry, and have the characteristics praised by Machiavelli, Friedman and Samuelson. Which world would you rather live in? Would it make a difference if there was a huge amount of wealth in the second world, while people lived simply in the first one? Clearly our lives are strongly shaped by the choices, good or bad, that people in our society make. Islam teaches us to prefer the simple life of our Prophet and the Companions, over the luxury and ostentation of Qaroon and Fir'own. The Quran (3:196) tells us not to be deceived by the apparent luxury of the unbelievers. This is in opposition to dominant western teachings which place selfish pursuit of luxury above any concern for the fate of the poor and the oppressed. These teachings influence humans to choose evil courses of action leading the current state of the world, where tremendous amounts of wealth concentrated in the hands of a few co-exists with huge amounts of misery and poverty for the masses of people. Islam teaches us to care for others over and above our self. The Quran (59:9) praises those who feed others, even though they themselves are in need. The Prophet Mohammad S.A.W. demonstrated that teaching people to make the right choices can change the course of history and the nature of the society we live in.

Lesson #2: Choosing the Good

To build a better world, we do not need more factories and fertilizer. Rather, we need to change the choices that human beings are making during the course of their lives. The Quran (90:10) states that Allah T'aala has "shown him the two highways [of good and evil]". That is, this world is a test, and man has a choice between good and evil. The Prophet Mohammed S.A.W. came to teach mankind good and evil, and how to make good choices in preference to evil ones. Today, the world is in a bad state because humans are constantly choosing evil over good. The Quran exhorts us to prefer the good, even though our desires favor the evil. To improve the state of the world, we must carry out the mission of the Ummah to spread the good and prohibit the evil.

Myth #3: Objective History is Possible

Another important way in which our mental models influence our lives is in our choice of history, which shapes our identities. The materialist view holds that there is only one unique objective history. In contrast, I would like to argue that history cannot be understood without a point of view. All points of view are automatically biased, and there is no such thing as an unbiased point of view. As a Muslim, I identify with Muslims who came to India to spread the benefits of the religion of Islam to the people living here. However, this same history could be entirely different if told from the point of view of the Hindus, Buddhists, or neutral third parties. What Indians call the war of independence of 1857 was a rebellion from the British viewpoint, and it could be called a battle between British and Indians from the Chinese viewpoint. The crucial point here is that there are no neutral, objective, and factual standpoints available. To minimize or legitimize British atrocities committed during the war is to deny validity to the native point of view. To fail to understand that exigencies of war necessitated harsh measures is to deny validity to the British point of view. Understanding requires simultaneous comprehension of alternative conflicting and contradictory narratives, and not that of a single unbiased and objective history. This is radically different from the conventional perspective that there is only one "true" and objective history.

History can never be objective because of many reasons. The complete historical record of all events that have occurred since the dawn of time is beyond the capacity of any human being to absorb and comprehend. Only a tiny portion of this history has been recorded, and there is strong evidence that only partisans record historical events – those to whom it matters. Even if we select and learn a hundred thousand facts, these will be a small and insignificant portion of the available historical record. There is no chance that such a small collection of facts will be representative, or provide some sort of an objective picture of the totality, which will remain forever inaccessible to humans. Typically we can know or learn only a very tiny percentage of relevant historical facts within the span of a lifetime. As a result, our knowledge of history is automatically biased, and this is a problem which cannot be remedied.

Truth #3: We Choose Our Past, which Shapes Our Future

It is only after giving up hope of achieving a perfect, objective and complete record of history that it becomes possible to understand what history is about. Our past is not engraved in stone and unchangeable, as we imagine it to be. Rather, we choose the stories we will tell about our past. There are so many stories that it is impossible to tell them all. We are free to choose the stories we tell about our past, and our choices create the world we live in – they become part of our mental representation of the world. The vast majority of what I consider my history is events that I have read about, not ones I have experienced. So we choose our past by choosing what to learn about our past. The stories we tell about our past will determine what we consider worth striving for, and also delineate the space of actions open to us.

We find three different schools of thought regarding Islamic history– all three believe in the possibility of objective history, and hence dispute among themselves as to which is the "true" history. One school of thought projects the past glories of Islamic civilization, and refuses to look at the dark side. Another school of thought finds only darkness, and virtually no saving grace. A third school believes that objectivity requires that every time we tell a good story about the Islamic past, we must balance it by telling a bad story. Which is the right approach? To answer this question we must consider why we want to tell stories about our past.

A naïve answer is that we want to tell the "true" story of the Islamic civilization. As already discussed, this is impossible. It is not humanly possible to present the true story of fourteen centuries of an infinitely diverse and complex set of social, cultural, economic and political interactions within the vast Islamic empires. The available materials are too vast to be studied within a lifetime of any human being, and what is not known is far greater than what is known.

Going beyond the simplistic "search for truth," history serves a varied and complex set of purposes which we cannot adequately summarize in a few paragraphs. Instead, we will just focus on a few points of relevance to what follows. History serves to define our relation to other human beings, and to the large scale human projects and visions which shape the world we live in. It provides meaning to our lives, by putting them in the context of a bigger picture. It provides a purpose and direction for our struggles.

Lesson #3: History as a Tool and Weapon

To understand the functions of history, imagine forgetting our history for a moment. Then we become just one anonymous individual, a drop in the ocean. History is what ties us to the past and connects us to the future, giving our life meaning beyond its finite span. To give a concrete illustration, consider the following summary of Islamic history by Marshall Hodgson (1977, p. 71):

> Muslims are assured in the Quran, 'You have become the best community ever raised up for mankind, enjoining the right and forbidding the wrong, and having faith in God.' Earnest men have taken this prophecy seriously to the point of trying to mould the history of the whole world in accordance with it. Soon after the founding of the faith, Muslims succeeded in building a new form of society, which in time carried with it its own distinctive institutions, its art and literature, its science and scholarship, its political and social forms, as well as its cult and creed, all bearing an unmistakable Islamic impress. In the course of centuries, this new society spread over widely diverse climes, throughout most of the Old World. It came closer than any had ever come to uniting all mankind under its ideals.
>
> …Those who have undertaken to rebuild life in Islamic terms have ventured on an enterprise with a high potential reward – that of winning through to the best that is open to mankind; but with correspondingly great risks of error and failure.

Understanding and absorbing this history makes us a part of an enormous enterprise to spread the good to the entire human race. This enterprise has spanned centuries and taken billions of people within its fold. We can identify with its successes and feel sorrow at its failures. Such a history provides courage, vision, perspective, and allows us to be philosophical, put up with short term defeats without losing hope. This is radically different from the bleak perspective of the single individual without history, who is necessarily confined to a single lifetime of experiences with no past and no future.

This is why we must tell stories of heroism and valor, instead of despair and defeat, so that our generations have the courage to face adverse circumstances. We must tie in our lives to bigger projects of mankind so that they acquire meaning. To select exceptional stories from our past, extraordinary examples of good behavior, is not "biased" history. This must be done to create inspiring role models; to allow us to persist in enjoining the good even against overwhelming odds. It is our tremendous good fortune that Islamic history has such extraordinary events. Our ancestors have done things which no other civilization can match. We just give one example, out of a thousand and one possibilities. The way that our Prophet Mohammad S.A.W. forgave bitter enemies, and celebrated the conquest of Mecca with humility, and a night of worship at Ka'ba, has been an inspiration for all Muslim conquerors. It stands in stark contrast with the idea that "all is fair in love and war," and the rapine and loot associated with conquest that is considered part of human nature by some writers.

European Conquest of the Globe

All of us who have had a western education directly or indirectly have absorbed certain key tenets of the dominant western world view. Biases in western accounts have now received wide recognition, and are labeled as "Eurocentric" ideas. We will label these ideas as "myths," even though they are perfectly valid and justifiable within their own context. This is because these ideas are extremely harmful to any genuine prospects for development for Muslim countries. We will focus on three central ideas, even though there are many other candidates, and many other ways of classification.

Myth #4: The Enlightenment

European historians tell us that the history of mankind begins in the 1650's in Europe with the Enlightenment. Before this, mankind as a whole was immature and ignorant, in a childlike state – the Dark Ages. The Age of Reason lifted the curtains of darkness in Europe, where mankind first learned how to think for themselves, and to understand the world around us. As a result, science, technology, democracy, and virtually all good things known to mankind were invented in Europe. Blaut (2000) has documented that popular and influential thinkers and historians like Weber, White, Mann, Hall, and Landes agree on the idea that "Europeans were uniquely capable of creative and scientific thought." Muslims see no reason to doubt these accounts, since Europeans are manifestly wealthier and more powerful than the rest of the world, and evidence of their technological prowess surrounds us in our daily lives, in the form of countless inventions. Believing these Eurocentric accounts of history leads to a serious inferiority complex. Salman Rushdie provides a perfect illustration: in his book called "Shame" he denigrates his family. In "Midnights Children," he denigrates his country and culture holding them up to public ridicule. In "Satanic Verses" he denigrates his religion and heritage. Cure for the "Rushdie Complex" lies in learning more about the Enlightenment and it consequences.

Truth #4: All Humans Participated in Creation of History

There are many ways to get a broader perspective on history, which provides deeper insights. It is impossible to cover these perspectives within a short essay, so we highlight some aspects of crucial importance for our present purposes. In the first subsection below, we discuss how the Eurocentric account seriously neglects the contributions of other civilizations. The second subsection highlights the Islamic contribution, as especially relevant to the project of re-writing history from an Islamic point of view.

4.1. Global Systems

World Systems point of view developed by Immanuel Wallerstein and others stresses the linkages between all the human beings living on the planet, as well as the linkages between the artificially separated spheres of knowledge of society, politics, and economy. The one sided Eurocentric view can be replaced by a much richer picture of the joint contributions of all humans in weaving the complex fabric of current society.

In *The Theft of History*, Jack Goody (2012) documents how Europeans borrowed and adopted inventions of other civilizations, and claimed them as their own. The Incas were master botanists and created maize by cultivating and cross breeding inedible and poisonous plants. Their inventions continue to feed the planet. Four great Chinese inventions of compass, gunpowder, paper, and printing have had a lasting impact on human history. Indian contributions in arithmetic, philosophy, manufacture of sugar, have been largely forgotten. Muslim discoveries in cartography, heliocentric astronomy, physics, optics, pharmacopeia and surgery have been largely suppressed, and European imitators have been put forth as originators of these ideas in current histories.

4.2. Islam sparks the Re-naissance

The Crusades created a hostility to Islam and Muslims in Europe which has survived to this day. The recent western wars against "terrorism" – modern euphemism for Islam – have been recognized and named as the modern crusades by many. While one dimension of these wars is the physical combat, perhaps the more important dimension is the ideological warfare against Islam, which creates doubts, shame, and loss of self-confidence among Muslims. Part of an antidote is to re-emphasize the Islamic contributions to the world. This involves reclaiming the treasures stolen via the *Theft of History* mentioned earlier. It also involves remembering the forgotten heritage of the Islamic civilization. A clue as to how this might be done is furnished by the following passage, taken from an introduction to Graham (2006)

> In the Middle Ages, while Europe was mired in superstition and feudal chaos, Baghdad was the intellectual center of the world. It was there that an army of translators and scholars took the wisdom of the Greeks and combined it with their own cultural traditions to create a scientific, mathematical and philosophical golden age. Their accomplishments were staggering, including the development of modern medicine, chemistry, and algebra. Muslim scientists correctly calculated the circumference of the globe in the tenth century. Muslim musicians introduced the guitar and musical notation to the Europe. And Muslim philosophers invented the scientific method and paved the way for the Enlightenment. At the dawn of the Renaissance, Christian Europe was wearing Persian clothes, singing Arab songs, reading Spanish Muslim philosophy and eating off Mamluk Turkish brassware. This is the story of how Muslims taught Europe to live well and think clearly. It is the story of how Islam created the Modern World.

Morgan (2008) highlights Muslim contributions which most Muslims do not know today, as they have forgotten their heritage. Among the greatest inventions of the Muslims are ideas which have become marginalized due to the excessive worship of gold which has become the religion of the economists. These are the ideas of equality of human beings, brotherhood, and mutual responsibility. In "The Enlightenment Quran" Ziad El-Marsafy (2009) has documented the influence of the Quran on Rousseau and Voltaire, as well as other Enlightenment thinkers. The slogans of "Liberty, Fraternity, and Equality" of the French Revolution derive from the Quran. These ideas were implemented in Muslim societies in the form of equal opportunities for education and free health care by waqf institutions in a way that has only recently been matched in some, but not all, Western societies. After observing the senseless slaughter of millions in the two world wars, historian Toynbee (1960) was moved to say: "The extinction of race consciousness as between Muslims is one of the outstanding moral achievements of Islam. In the contemporary world there is, as it happens, a crying need for the propagation of this Islamic virtue … of tolerance and peace"

Myth #5: The White Man's Burden

By the late nineteenth century, people of European origins had control of about 90% of the planet Earth. Why and how did this happen? The answer to this question is crucial to understanding the world we live in today. The standard story, which is widely believed, ties in to the Enlightenment myth. After having been given the gifts of reason, science, technology, democracy, and other treasures, the Europeans looked around them and saw that the entire world was in darkness. Ignorance, cruelty, superstition, despotism, and all kinds of evil were spread throughout the world. The Europeans had grown up, while all other human beings were in the stage of infancy. Like Prometheus, they felt burdened by the responsibility of taking these gifts of the Gods to the entire mankind. Out of this sense of responsibility, they sacrificed the comforts and luxuries of their homes, and undertook the hardships of strenuous journeys to all corners of the globe in a noble effort to spread these benefits to all of mankind. Ignorant barbarians who resisted these advances were eliminated in the "savage wars" to bring peace and enlightenment to the planet.

Truth #5: Loot and Pillage of the World

The announced purposes of the US Invasion of Iraq were to free the populace from the clutches of an evil dictator, to bring them democracy and good governance, as well as to protect the world from Weapons of Mass Destruction in the hands of a madman. Senior White House officials like Henry Kissinger, Paul O'Neill and Alan Greenspan have stated that Iraq war was planned for the control of the vast oil reserves of Iraq; see Weissman (2007) and Cohn (2013). The discrepancy between the announced goals, widely believed by the USA public, and the (not-so) hidden agenda corresponds closely to the discrepancy between the story of the White Man's Burden and the real objectives of colonization of the globe.

Finding overland trade routes blocked by powerful Islamic empires, Europeans sought sea routes to fabled lands of India, China and others. However, these European explorers were indifferent between murder, theft, piracy and trade as means to make a profit. When Columbus failed to find the gold he had promised to the financiers of his voyage, he captured slaves instead. When the East India trading company conquered Bengal using treachery and a hired army, they imposed heavy taxes leading to death by starvation of 10 million Bengalis. To bring them the benefits of European civilization, Belgian King Leopold taught the Congolese Western work ethics: the Belgians took wives and children hostage and kept them in subhuman conditions until their African husbands fulfilled their quotas harvesting rubber. Soldiers would torture, chop off hands, or kill the inhabitants if they faltered in their work. This resulted in the deaths of 4 to 8 million Africans in the Belgian Congo. This dirty work was advertised as a Christian charity for the benefit of the Congolese natives by the Belgians.

In the mid-eighteenth century, Bengal was the most prosperous region in the area, with abundant crops and advanced industries in textile and steel. Following the British conquest at Plassey, within a period of ten years, rapacious tax polices led to death by starvation of more than one third of the population. The annual transfers of about 30 million pounds from India to the Empire, and prohibitions of development of industry, led to de-industrialization, and repeated famines in a once prosperous land. In real terms, revenues extracted from British India were far larger than those provided by the US to Europe under the Marshall Plan, which permitted European Economies to recover from the complete devastation created by World War II.

Similarly exploitation of Africa, led to complete destruction of several native empires and cultures. To the misfortune of Africa, they had no natural resources. As a result, the human beings were made the objects of a devastating slave trade. Numbers are in dispute, but over 10 million human beings were transported to serve as slaves in Europe and America. It is estimated that for every person transported, about 10 died in the brutal processes of capture and transport. The social fabric of the cultures that constituted Africa was destroyed beyond the hope of reconstitution. Because materialists cannot see social capital, thousands of pages of contemporary journals research the mystery of exceedingly poor rates of economic development in Africa, without touching on its root causes. Similar fates met the indigenous peoples of Latin America, North America and Australia. The world was enslaved to serve as a production factory for European capitalists. For those with a conscience, the White Man's burden of guilt is heavy. Herder (2010, p 206) writes, ironically, that:

> Savages all over the world will become ripe for conversion as they grow fonder of our brandy and our luxuries; they will soon approach our culture and become, so help me God, good, strong and happy men, just like us! … In Europe slavery has been abolished … . Nonetheless this did not prevent our raiding three other continents for slaves, trading in them, banishing them to silver mines and sugar plantations. But then, they are not European, not Christian! What is more, we get silver, precious stones, spices, sugar and - secret diseases, in return.

Lesson #5: The Ethics of Imperialists

We have all absorbed the dominant myth, that we are now modern and "civilized" and far more advanced than any other civilizations of the past. It is time to take a deep breath and consider an alternative, frightening possibility. Temporarily forget current history and world situation and make your mind a blank slate. Consider for a moment, a situation where barbarians, like the Huns, and Visigoths and Mongols, who razed cities and enjoyed building mountains of skulls of innocent victims, take over the world. What kind of ethics would they promote? What would be their philosophy of life? In other words, what is the opposite of civilization?

A key element in a barbarian philosophy would be the law of the jungle: might makes right. If we can get it by force, than it is rightfully ours. Another element would be lack of compassion and sympathy; we cannot afford to feel pity for the victims of our loot and pillage. Destroying cities and nations, and killing millions of innocents should not disturb our conscience or cause loss of sleep. Another element would be that life is about gathering wealth and enjoying the luxuries and privileges that it entails, without any regard for others. Similarly, the philosophies of cut-throat competition and let the best man win would be a good match for a barbarian life style. Betrayal of oaths of fidelity to intimate relations would be a joking matter, rather than a serious breach of integrity. Barbarian children would play games teaching them to shoot and kill and enjoy watching blood, gore and guts spill out of random strangers, or even friends. Movies and media would teach people to enjoy sadism and senseless violence, and to regard assassins, thieves, prostitutes and other highly immoral characters as normal human beings.

Now open your eyes and consider the world we live in. The world leader USA felt no compunction in launching the Iraq war under false pretenses which has resulted in the loss of more than a million civilian lives. Deliberate destruction of Iraqi infrastructure including hospitals, schools, and water/sanitation works, ruining the lives of millions of Iraqis, was carried out to create profitable business opportunities for the "re-construction" of Iraq. US Secretary Madeleine Albright stated on public TV that death of half a million Iraqi children was a price worth paying for achievement of US policy objectives. In the first lecture on Justice to the future world leaders in a Harvard undergraduate course, Professor Michael Sandel (2013) constructs complex artificial situations where it might be necessary to do murder or cannibalism for the greater good. He states that moral questions have been argued for thousands of years without reaching any resolution. The goal of the lecture is to show that there are no absolute standards for morality, and evil acts may be justified if they lead to larger benefits. This is essential training for future leaders who may have to condemn millions of innocents to violent deaths, in pursuit of higher goals like corporate profits. Dominant economic theories state that the object of life is to maximize consumption, without any regard for others. Thus we live in world where 25,000 people die every day from diseases related to malnutrition, when the money spent on fighting obesity and obesity related diseases would be enough to end hunger on the planet. Ph. D. economists learn to value academic careers, but do not learn anything about how to help improve the lives of the impoverished bottom billion. Leading textbooks in growth theory state that if we maximize the wealth for society as a whole, it will automatically trickle down to the poor – even though this has been repeatedly disproven empirically. Dominant economic theories hold that the best way to organize business is via cut-throat competition, as this will lead to maximum efficiency. Ruthless exploitation of the world by multinationals unrestrained by ethical concerns has brought the world to the brink of environmental catastrophe. These theories are currently being taught at leading universities throughout the world. The lessons thus absorbed create the world we see around us.

An essential element of the struggle for good must be to replace these barbaric theories by more humane alternatives.

Myth #6: Secrets of European Conquest

Granted that global conquest was not achieved via surgical strikes which precisely and accurately eliminated evil, without affecting the good. Admittedly, there was a lot of collateral damage; millions of innocents lost their lives in the "savage wars of peace" meant to bring enlightenment to the planet. Nonetheless, we must admit that the Europeans did conquer the world. This is not a small feat. They must be superior in many ways in order to achieve it.

Many have searched for reasons and explanations for this European superiority. To the early writers, it was obvious that the White race was superior to others, and this was the reason why they conquered the world. Blaut (2000) has listed thirty Eurocentric explanations for the rise of Europe to global dominance. Even though he has debunked them all, these explanations are offered by very respectable and influential academics, whose views continue to be cited and to shape mainstream views of history. As an illustration, we list five of these thirty reasons below, many of which have popular books devoted to amplification and justification.

1. People of the white race have an inherited superiority over the people of other races.
2. Europeans were uniquely rational, innovative and progressive.
3. Europeans were uniquely capable of creative and scientific thought.
4. Europeans uniquely, in ancient and/or medieval times, developed the concept and institution of private property and/or that of markets.
5. Europeans were uniquely venturesome, uniquely given to exploration and overseas expansion.

Several authors have debunked these myths, showing that Europeans were not unique in the ways imagined above. That still leaves us a puzzle: how to explain the rise of the West? We offer a simple alternative to the dominant theories listed above. Throughout history, advanced civilizations become decadent, and are defeated and destroyed by youthful, energetic barbarian tribes. Ibn-e-Khaldun (2004) noted this as a regular cycle in his history. The defeat of Muslims at the hand of Europeans has striking similarities to the earlier destruction of the Muslim civilization by the Mongols. More specific evidence is provided below.

Truth #6: A Comparative Advantage in Violence

An amazingly large number of different ideas have been presented as causes of the Rise of Europe, and new theories continue to come up. The vast majority of these are materialistic explanations, based superiority of European lands, or resources, or humans. We would like to propose an idealistic explanation. Certain unique European ideas, different from those prevailing among the rest of humanity, led to the global conquest. We list three European inventions which eventually led to the conquest of the globe by Europe.

Glorification of War

Hoffman (2012) provides an explanation of the European comparative advantage in violence in the following terms:

> In Europe, the kings and princes had been raised to fight one another, with toy soldiers, pikes, and firearms as children and actual training in their youth. Advisers like Machiavelli might tell them that princes "ought to have no object, thought, or profession but war." Their own fathers would teach them that war was a path to glory, a means to "distinguish [kings] . . . and to fulfill the great expectations ...inspired in the public," in the words of Louis XIV's instructions for his son. They took the lesson to heart and once enthroned often surrounded themselves with images exalting their role as military leaders or glorifying the martial exploits of their reigns, as Louis XIV himself did at Versailles. And they pursued war with gusto, at least if they ruled over a major power. Fighting had gone beyond the needs of defense and become, in the words of Galileo, a "royal sport."

The glorification of war, and its acceptance as a natural state, led to the Military Revolution of early modern Europe, discussed by Geoffrey Parker (1996). This was a product of the intense rivalries between the nascent nation-states that led them to make significant innovations in strategy and tactics, armament, and logistics. This was done efficiently by the use of gunpowder, which was substantially advanced in the West. Nearly three centuries of continuous warfare in Europe gave them a "comparative advantage in violence," as Hoffman (2012) puts it. The trend continues to this day, where leaders of US and UK find the most effective boost to lagging popularity to be good fortunes in a war. For instance, victory in Falklands brought popularity to Thatcher, and victory over Russians made Reagan poular. D'Ambrosio (2011) has documented the dramatic difference between the Hollywood glorification of war in Sands of Iwo Jima, and the tragedy of it in the real life of the war hero Ira Hayes. In contrast, the vast majority of the rest of humanity enjoyed and preferred peace to war. For example, Hoffman (2012) writes that the Jesuit missionary Matteo Ricci, who died in Peking in 1610 after spending 28 years in China– noted that although the China could easily conquer neighboring states neither the emperors nor Chinese officials had any interest in doing so. "Certainly, this is very different from our own countries [in Europe]," he noted, for European kings are "driven by the insatiable desire to extend their dominions."

Children learn from the popular computer game "Civilization" that the goal is to achieve global dominance by destroying other civilizations. Among societies which have experienced it, civilization has an entirely different meaning. As Gandhi put it: "Western civilization? I think it would be a good idea."

Insularity, Intolerance, and Racism

For reasons too complex to describe here, Europeans never managed to develop the cosmopolitan culture of the Ottomans or of Islamic Spain. There is some truth in the lyrics to a popular song " …The French hate the Germans. The Germans hate the Poles. Italians hate Yugoslavs. …" It is hard to tell if the perpetual warfare in Europe was a cause or an effect of this; it seems likely that there was mutual reinforcement of inherent tendencies. One of the driving forces behind the development of the European Union was the hope that tying the countries into interlocking economic relationships would be a way to prevent the warfare which has characterized European history.

This warfare eventually led to the development of "nationalism," perhaps the most deadly philosophy invented by man. Millions died for their countries in the two conflagrations named as world wars in the twentieth century. The idea that perpetual warfare is the natural state of being between different nations has become deeply ingrained in the European psyche. Countless fictional works (like the War of the Worlds) as well as academics assume that encounter between different nations must necessarily be on hostile terms. The most recent example is the "Clash of Civilizations" by Samuel P. Huntington (2011). The idea that two civilisations can meet, learn from each other, trade, enjoy benefits of mutual friendship simply does not occur to Huntington and similar scholars in the European tradition. It is assumed that war, conflict and attempts by one to dominate the other must inevitably result from contact as this is the lesson of European history.

Racism was rampant, and there was near consensus that non-white races were not fully human. Thus Europeans had no compunctions in hunting Australian aborigines like animals, and in shooting and killing the inferior races. In the US Supreme Court decision Dred Scott v. Sandford issued on March 6, 1857, Chief Justice Roger Taney declared negroes to be "beings of an inferior order, and altogether unfit to associate with the white race, either in social or political relations, and so far inferior that they had no rights which the white man was bound to respect." Lord Cecil Rhodes (1902) declared that "I contend that we are the finest race in the world and that the more of the world we inhabit the better it is for the human race. Just fancy those parts that are at present inhabited by the most despicable specimens of human beings; what an alteration there would be if they were brought under Anglo-Saxon influence ... " The millions of pounds transferred from the colonies of inferior beings to the white colonizers led to Lord Cecil Rhodes becoming the richest man on the planet. Western academics have argued that these transfers were just and equitable payments for the good governance provided to the colonies. The same process continues today, using different mechanisms. Shah (2005) provides the following statistics regarding money transfers from the poorest countries to the rich: For the poorest countries (approximately 60), $550 billion has been paid in both principal and interest over the last three decades, on $540bn of loans, and yet there is still a $523 billion dollar debt burden.

All is Fair in Love and War

Since warfare in Europe was often justified on religious grounds, European intellectuals sought a secular political philosophy as an alternative to religion. The "social contract" became the secular basis of morality. Hegel noted that the social contract was by consensus within a nation-state. If the state lost a war, then the conquerors would re-write the social contract and thereby re-write morality. To defend themselves, states could act in ways that went beyond any moral codes – states create morality and therefore are not bound by it. This creates a justification for any atrocity "for reasons of the state." Glover (2012) has noted the dark record of the many atrocities committed in the twentieth century. For example, continuation of British blockade of food to Germans after the surrender of Germany, led to death by starvation of about 800,000 Germans. Bauman (1989) has analyzed the Holocaust, in which million of civilian Jews – men, women and children – were scientifically exterminated in specially designed ovens. Baumann argues that the rational philosophy that ends justify means, which continues to be taught at leading universities, was, in the final analysis the cause of the holocaust. That is, lack of absolute moral codes have caused, and will continue to cause human disasters.

Another unique European invention is the philosophy of social Darwinism. The advent of British colonization of Africa coincided with the era of scientific racism as represented by social Darwinism (survival of the fittest). The British believed that because they had superior weaponry and were therefore more technologically advanced than the Africans, that they had a right to colonize and exploit the resources of the Africans in the name of promoting civilization. It is, of course, inherently contradictory for an invading force to usher in "civilization."

Similarly, no other civilization can offer a parallel to Machiavelli, whose wisdom continues to guide Western leaders. He advised princes to be cunning and duplicitous, to command by fear, rather than love, to deceive by making and breaking promises, and to be ruthless in treatment of enemies. This was taken to heart and made the base of western politics; political scientist Ludlow (2005) has documented how faithfully US Politicians follow Machiavellian prescriptions. The western conquest of the globe was accompanied by unmatched ruthlessness and treachery, as has been documented in numerous "subaltern" accounts that have emerged – for a moving example of the native American perspective on the English-

American conquest of the continent, see Brown (1991). As Machiavelli had correctly foreseen, the vast majority of people are simple and honest, and hence easily deceived.

Lesson #6: Finding Other Pathways

The primary lesson of "modernization theories" is that Europeans have reached the apex of civilization, and we must imitate them to achieve their success. There are two fundamental difficulties with this idea. Firstly, it is not possible for us to conquer the globe and the loot the wealth of other civilizations, in order to imitate the European formula for success. Secondly, even if it was possible, it would not be desirable for us, as human beings, to achieve the comparative advantage in violence, ruthlessness, and treachery that led to the European conquest of the globe. Simplicity and honesty are precious human qualities, to be prized over cunning and ruthlessness.

It is true that the so-called "underdeveloped" world is in very bad shape. We were living peacefully, when alien invaders came and destroyed local institutions and cultures. All natural resources were captured as raw material to feed capitalist production processes. All of the population was turned into cogs of a capitalist machine designed to maximize production and wealth at the center. Instead of developing human potential, an educational system was designed to teach students that the goal of life is to sell their labor for money. Those who did not cooperate were ruthlessly eliminated as being obstacles to progress. Our best minds have absorbed these lessons of a western education, and sell their services to the west for high salaries, depriving the Ummah of precious manpower. The ideals that service to mankind and Ummah takes precedence over a life of personal luxury have been forgotten. It will be very difficult to recover from this damage. Creative strategies are required. The first step is to liberate ourselves from the narratives of Eurocentric history, which prevent us from looking in the directions required for progress. This essay provides the foundations for alternative sketch of history.

Decline and Fall of the East

Corresponding to myths of European superiority, we have myths of Eastern inferiority. After all, it was necessary to come up with some justification for the ruthless exploitation of human and natural resources of the entire planet. Although the myth of racial superiority has lost intellectual respectability, it still survives in covert forms. It is worth stating and rebutting since swallowing the myth leads to despair about the possibilities of change and improvement. This despair is itself one of the biggest obstacles to change.

Myth #7: Superiority of the White Races

There was an intense debate in the 1980's about the Eurocentric bias of a course at Stanford which taught the Great Books of the Western Civilization. While some advocated including books from other traditions and civilizations, there was a minority which publicly expressed the view of Lord Macaulay (1958) that "a single shelf of a good European library was worth the whole native literature of India and Arabia." Perhaps the majority was in agreement, but remained neutral due to pressures to be politically correct. Similarly, the issue of whether or not the Muslims can "self-govern" has been debated at the highest levels in USA. Harvard professors Herrnstein & Murray (2010) have published the "The Bell Curve" which suggests that Blacks are genetically inferior to Whites in intelligence.

Some years ago, in the process of researching education in Pakistan, the World Bank administered some intelligence tests via a large, expensive, and time-consuming survey to a target population. Dr. Ali Khan of Johns Hopkins was assigned to review the project. He noted that the particular tests administered were designed for people of subnormal intelligence. It had been well established in the psychological literature that these tests had no validity for people of normal intelligence. As another observer remarked, the World Bank experts consider the people of Pakistan to be morons[1].

The idea of racial superiority of the whites has played a far greater role in history than has been recognized. Entire peoples were exterminated and enslaved in Latin America, Africa and Asia in order to capture their natural resources. This would not have been possible if these "miserable specimens" of inferior beings had been regarded as human beings equal to the Whites. What accounts for the difference between the development trajectories of Australia, USA and India, all former colonies of England?

Racism allowed ruthless exploitation of one, and prohibited equally ruthless exploitation of the others. Even today, the same lessons are being applied. The destruction of the entire nation of Iraq in order to capture its oil resources is only possible because Arabs are not fully human. It would not have been possible to carry out this war if Iraq had been part of Europe or peopled by whites.

Truth #7: Brotherhood

Against this myth, there is strong evidence that all human beings belong to a common genetic pool, and hence are genetically equivalently endowed. The idea that only Europeans have accomplished great things is based mainly on ignorance – Macaulay (1958) acknowledged that he did not know a word of Arabic or Sanskrit, in the same tract in which he condemns the entire literature. When Australian aborigines were being hunted as animals, they had the knowledge to live off the land which Australian immigrants lacked and hence had to face frequent famines in a land of plenty; see Hughes (2010). Similarly, all civilizations have made original contributions and achieved excellence in ways that others have not.

Lesson #7: The Courage to Make a Difference

The Quran asserts that man can only get what he strives for. The false idea of racial inferiority, and the false idea that our ancestors never accomplished anything worthwhile, limits the range of our ambitions. Once the lesson of brotherhood of all human beings is absorbed, it becomes possible to strive for the highest goals that humans have tried for. These highest goals are NOT, contrary to dominant myths suitable for looters of the world, the maximization of wealth. Rather, every man has been given the potential to become superior to the angels, and also the capability to be worse than the beasts. Depending on the environment and the efforts made, men can develop to a greater or lesser extent. Those who remain undeveloped spiritually can, like Machiavelli, prefer to rule by fear, because they cannot sense the warmth in the hearts of fellow men. They can drop fire bombs on cities, frying human beings on hot pavements, without feeling any compassion. Spiritual development leads to an awareness of the linkages between all human beings. The most developed of all human beings was our prophet Mohammed S.A.W. who was sent as a mercy for all mankind. His heart was so full of compassion that Allah T'aala counsels him in the Holy Quran not to kill himself with sorrow on the behalf of those who would not believe and thereby condemn themselves to eternal suffering. Our goal in life is to try and emulate this excellence, to the extent possible for us. This does not involve maximizing happiness, as the utilitarians believe. Rather, it involves the opening of our hearts to all of the creation of God, which may result in increased suffering, because we are able to feel the pain of others.

Myth #8: Oriental Despotism

Just as the liberation of Iraq was a convenient pretext for its invasion, so the idea that the world was governed by despots and dictators furnished a convenient excuse for invasion by colonizing imperialist powers. Examining the history of the idea, Armagan (2006) documents how the idea of "despotism" has been used for centuries as a means for slandering systems of government which differ from western systems. The term is conveniently flexible, and can be stretched to fit many molds – four different interpretations and usages are identified by Armagan. Figueria (1995) has examined how the myth of oriental despotism was useful, became widely accepted, and was adapted for a variety of political purposes in European literature, without having any contact with the reality of Eastern history. Eisenstadt (2003,Chapter 17, p. 418) writes about the Myth of Oriental Despotism that "According to this very widespread myth in large parts of Western analyses of Asian politics, these societies were ruled by Oriental Despots, and of the political regimes that developed within them as Oriental Despotism, in which all power was seen as concentrated within the hands of the rulers, and the various sectors of the society were not granted any autonomy beyond purely local affairs, and even these affairs were tightly regulated by Great Despots." Similarly, Balahnova (2005-6) revisits the idea that the Eastern societies were "despotic societies". She collects a lot of examples demonstrating that there were some democratic states among Eastern societies, and even in the societies where the royal power was really strong, the kings were limited in their desires by law. And even such social categories which we consider slaves were protected under the law.

Edward Said's (1978) book "Orientalism" is the classic study of how myths about the East were manufactured in the West. The unfortunate part is that even the Orientals learn their own history from these western accounts and therefore end up believing these myths. Thus they believe that democracy was invented in the west, that our societies have always been autocratic, and that this is one of the reasons that we are "backwards", and will remain backwards.

Truth #8: Destruction of Well Functioning Societies.

Entirely contrary to the enlightenment myth, the world was not in darkness when the Europeans managed temporarily to forge peace among themselves by agreeing to conquer the world instead of fighting each other. All over the world, in all cultures, there was a wide variety of functioning systems for education, health, social welfare and justice. These systems were of no use to the imperialist invaders, and were completely destroyed in the process of colonization. The destruction was so thorough that not even the memory remained within indigenous populations:

> *Oh! the loss of the treasures of the caravan; Even worse, the loss of the sense of loss*. – Iqbal (free translation)

New educational systems were put in place which had two functions:

1. To indoctrinate student to love the imperialists and hate their own roots, heritage and ancestors.
2. To train bureaucrats, administrators, armies, and other personnel required for the governance of the empires.

This training was essential to create people who could ruthlessly exploit their own people on behalf of the alien invaders. As Lord Macaulay (1958) put it: *We must at present do our best to form a class who may be interpreters between us and the millions whom we govern, --a class of persons Indian in blood and colour, but English in tastes, in opinions, in morals and in intellect.* A special class of people who would act on behalf of the imperialists was created in all the lands conquered by the Europeans. In return for power, wealth, and special privileges granted to them by the European ruling class, the *compradores* betrayed the interests of their own people by acting on behalf of the imperialists. This class, not recognized clearly, plays a very important role in the world today. Frantz Fanon (2008) studied how the psyche of Africans is distorted by dominance of whites. Dabashi (2011) emphasizes the importance of this "compradore" class in the Islamic Mediterranean.

All Muslims are required to learn the Quran, which has led to traditionally high literacy rates within Islamic societies. Muslims paid heed to the call of the Quran to spend generously of their wealth in charity. As a result, an extensive numbers of properties were donated as trusts (Awqaf). These provided for health, education and social services throughout the Islamic lands. These were systematically seized and appropriated by colonizers, and nothing was put into place to replace them. This led to creation of illiteracy, misery, poverty, famines, and social problems on a huge scale, in previously well functioning societies. Similar processes occurred in all colonized societies as functional systems of self governance were replaced by colonial systems designed with a single minded focus on economic exploitation. Entire societies were completely uprooted and destroyed. As a single example among many, Elkins (2005) author of *Britain's Gulag: The Brutal End of Empire in Kenya* writes that:

> I discovered that British forces wielded their authority with a perverse colonial logic: only by physically and psychologically atomising almost the entire Kikuyu population of 1.5 million could colonial authority be restored and the civilising mission reinstated.
> I used archival evidence collected in Kenya and Britain, along with eyewitness testimony that I collected from hundreds of detention survivors. A number of former detainees told me that electric shock was widely used, as well as cigarettes and fire. As I wrote: "Bottles (often broken), gun barrels, knives, snakes, vermin, and hot eggs were thrust up men's rectums and women's vaginas. The screening teams whipped, shot, burned, and mutilated Mau Mau suspects, ostensibly to gather intelligence for military operations, and as court evidence."

It is very important to understand that colonial structures of education, justice, governance, policing, markets, taxation, transportation etc. were all designed for maximally efficient extraction of resources from the native population. In all of the colonies, these were top-down structures – the population had no say in governance, and no opportunities to voice complaints. The Americans successfully rebelled against "taxation without representation," and the Australians were granted self-governance, but the rebellions of the lesser races were ruthlessly crushed.

Understanding colonial governance structures and their purposes is of extreme importance in understanding the nature of the world we live in today. The myth that these were meant for the benefit of the natives is widely believed. For example, the infrastructure of roads and train-tracks is considered a gift of the British to the Indian Empire. In fact, these were explicitly constructed to enable quick transport of troops to put down anticipated rebellions. As we have seen, native educational systems were destroyed, and alternate systems were designed to produce subservient administrators for the empire. Similarly, transport systems were designed all over the colonies to allow extraction of raw materials and for convenient supply of exports from the mother countries. Local justice systems were shut down, and alien justice systems introduced which made justice almost entirely inaccessible to the vast majority of the populace. As an illustration, George Monbiot (2012) reports on British suppression and concealment of records of its imperial atrocities:

> The story of benign imperialism, whose overriding purpose was not to seize land, labour and commodities but to teach the natives English, table manners and double-entry book-keeping, is a myth that has been carefully propagated. Last week's revelations, that the British government systematically destroyed the documents detailing mistreatment of its colonial subjects, and that the Foreign Office then lied about a secret cache of files … was ignored by … the British press.

Suppression of evidence was scarcely necessary. Even when the documentation of great crimes is abundant, it is … simply ignored. In an article for the Daily Mail in 2010, for example, the historian Dominic Sandbrook announced that "Britain's empire stands out as a beacon of tolerance, decency and the rule of law … Nor did Britain countenance anything like the dreadful tortures committed in French Algeria." Could he really have been unaware of the history he is disavowing?

The myth of a "benign imperialism" suggests that there were no adverse effects on development of the colonies even though millions of pounds of resources were siphoned off yearly, and entire populations virtually enslaved to serve imperialist aims. This myth is extremely harmful as it serves to divert attention from the root causes of "under-development". Without a correct diagnosis of the causes, it is impossible to administer a correct remedy.

Lesson #8: Rebuilding from Ruins

Weber (1930, Chapter 2) wrote that the "spirit of capitalism" is the pursuit of wealth as an end in itself, to the point of being "absolutely irrational."Rapacious greed of multinationals has led to tremendous damage to environment. Nearly every day, many kinds of birds and plants species become extinct due to loss of habitat. The last bird of its kind issues mating calls, but there is no one left to hear. Once they die out, there is no way to re-create them.

Over the past few centuries, large numbers of ways of living, cultures, languages, ways of thinking about the world, and ways of relating to other humans, have been destroyed beyond the possibility of re-building by the processes of colonization. The philosophy of survival of the fittest, which continues to dominate western political thought, suggests that this is a good thing. The power to destroy other civilizations confers the right to do so. The new generations in the colonies have been brought up on the myths that their ancestors were inferior sub-humans, and that hope and progress lies only in imitation of the west. The resulting inferiority complex prevents the formerly colonized peoples from thinking for themselves. Instead, foreign experts tell us what problems we face, and how we can solve them.

It is necessary to create less Eurocentric histories, and emphasize accomplishments of non-Europeans, in order to create self-confidence among the colonized people. Only this will allow us to look for ourselves at our problems and create the solutions. The list of 20 issues in the new Washington Consensus does not include any of the problems which are of high priority for us to solve. Efforts are wasted in discussing irrelevant and peripheral matters, while urgent and burning issues are ignored. Methods of solutions based on using local strengths and resources do not figure in solutions given by western experts. For example, there is no mention of Zakat and Islamic injunctions for generosity and charity in the IMF plans for reduction of poverty in the Islamic world.

Myth #9: Blaming the Victim

Suppose that I hit another person on the skull with a hammer. His skull breaks open, and his brains spill out. Now I call in the learned doctors to do research on the skull. They find manufacturing defects and structural weaknesses in the skull, which led to this failure to perform under stress.

In this section, we discuss several myths of this nature about development. For instance, in the pre-Civil War slaving USA, Negroes were not taught how to read and write since they were not considered capable of learning these skills. At the same time, their general inability to read and write was cited as a proof of their lack of capability for doing so.

In his book "The Wealth and Poverty of Nations," Professor David S. Landes (1999) contrasts the characteristics of successfully industrialized nations--work, thrift, honesty, patience, and tenacity--with those of nonindustrial countries. Thus our failure to develop is because we are lazy, dishonest, extravagant spendthrifts, and lack the strength of character to persevere in face of difficulties. This breathtaking ignorance and racism among the educators of the nation would deserve ridicule, but for the serious tragedy it leads to. When the culture of violence necessary for global domination led an unstable youngster, Adam Lanza, to murder 20 children in a USA school in cold blood, the nation mourned. No compassion or sympathy was expressed in the press for the million civilians killed and the 40 million lives of the inferior humans destroyed in Iraq.

Hernando de Soto (2003) propounds the influential thesis that secure property rights in the west led to development, and lack of them in the east led to failure to develop. Secure and accurate systems for demarcating and settling property rights had functioned for centuries in India. In a land grab typical of imperialists everywhere, "Resumption" officers demanded documents of ownership, and declared them invalid at the slightest pretext, seizing all undocumented property for the British. This led to closure of schools, hospitals, and indigenous social welfare organizations funded by trusts, throughout India – officers in charge of the resumption proceedings admitted that "they were harsh in the extreme." Similar arbitrary seizures of property via force majeure or legal trickery occurred in the colonies throughout Africa, North and South America, and Asia – upsetting centuries of traditions of settled land use rights.

Different authors have attributed our current poverty to our lack of creativity, inability to think rationally, authoritarian traditions, etc. which led to our failure to have an industrial revolution. Kennedy (1989) provides evidence for the strong industrial manufacturing sectors of India on the eve of colonization. In textiles, ship-building, steel industry, and glass blowing, among others, India was second to none. The Indian manufacturing sector was creative and efficient, and many technologies flowed from India to the backwards England. However, adoption of power looms in India posed a threat to British textiles and were banned. When muslin weavers shifted to hand production, their thumbs were cut off to prevent production of competitive muslins. Similarly many attempts at development of industry, tanneries, and even indigenously invented steam engines, etc. were prevented directly by British intervention, which saw the future of India as a supplier of raw materials to England, and not as a producer of industrial goods. This transformed India from an industrial country to an agricultural one, and lead to deaths in large numbers of those who had once earned comfortable livelihoods from industry. In a confidential note, William Bentinck, Viceroy of India stated that "the bones of the cotton weavers are bleaching the plains of India. The misery hardly finds a parallel in the history of commerce" (see Ghosh & Ghosh, 2011, p 26). It was not that we failed to industrialize – rather, we were de-industrialized in the process of colonization. Similarly, attempts to modernize and industrialize throughout the Islamic world (such as the effort by Mohammad Ali in Egypt) were blocked and defeated by active Imperialist policies, which opposed such ventures.

Truth #9: Opposite Sides of the Same Coin

More baffling than what is being said about the cause of development is what is NOT being said. In early twentieth century, European powers had direct or indirect economic control of about 90% of global resources, which they ruthlessly exploited to the hilt, not being constrained by moral considerations. The imperialists became rich, and the colonies became poor in the process. Is this such a mystery? None of the authors listed above mentions this as a possible explanation of why rich countries are rich and why the poor countries are poor. This is such a simple explanation that it is a mystery why no one refers to it, and the solitary text which provides detailed documentation validating this thesis has been out of print for decades. We quote from Stavrianos (1981):

> The "backwardness" of colonial peoples was taken for granted. The "natives" were viewed as inherently different from and inferior to, their European rulers. … Colonial rule generally was considered to be not the cause, but the only feasible solution for the prevailing backwardness.
> …it is beginning to be realized that the underdevelopment of the Third World and the development of the First World are not isolated and discrete

> phenomena. Rather they are organically and functionally interrelated. Underdevelopment is not a primal or original condition, to be outgrown by following the industrialization course pioneered by Western nations. The latter are overdeveloped today to the same degree that the peripheral lands are underdeveloped. The states of developedness and under-developedness are but two sides of the same coin.

If, as seems eminently plausible, under-development and development are opposite sides of the same coin, then remedies for under-development must be sought in radically different directions.

Lesson #9: Power and Knowledge

The truth is very damaging to the colonizing powers, who are still very much in control of the world. This truth has been ignored or suppressed, and myths have been developed to distract attention. It is thus that structures of knowledge support existing structures of power. Dangerous knowledge, of the type being discussed here, is a threat to status quo.

Defining Progress and Development

One of the most fundamental myths is that of western progress. That is, over the past few centuries, the west emerged from obscurity and became world leaders. Obviously, this means that they have progressed and that this is a feat worth emulating. The deeply entrenched language of "development" and "under-development" reflects this assumption. To deny this seems tantamount to denying the existence of rocks and trees, and the oceans and continents. Yet this is precisely what we propose to do. First, we must understand that progress is an idea that the mind imposes upon a sequence of historical events. There are no inherent flags in history itself which signal progress. In fact the measure of progress is carefully chosen by those with power.

For instance, when Great Britain ruled the waves, progress was related to sea power and other criteria which favored Britain. The Encyclopedia Britannica of 1930 does not contain an entry for the word "Democracy." After the two world wars depleted the wealth of the European powers, USA emerged as the world leader, and redefined the criteria for progress to be wealth – GNP per capita. When statistics showed that the per capita income of some oil kingdoms in the Middle East exceeded that of USA, the criterion was modified to require a reasonable income distribution. When Scandinavian countries went ahead of the USA in both GNP per capita and equitable income distribution, it was realized that the wealth of nations also lay in the infrastructure. The massive USA had huge networks of roads, dams, railroads etc. which could not be matched by the tiny European nations. The point is that we know in advance that the USA is the world leader, and only criteria which prove this "fact" are considered valid.

Two recent books with "lies, damned lies, and statistics" in their titles, graphically describe the power of statistics to deceive. After all, you can't argue with "facts". The sleight of hand involved in highlighting one set of facts instead of another is usually invisible to the audience. To pick one example at random, out of thousands available, a gruesome rape case in India was recently highlighted in the press. As pointed out by Vigo (2013):

> living in the UK and reading its media, one could easily think that rape solely existed in India and that there is only injustice against women in the subcontinent and other 'developing countries.' … (yet) … As recorded by the police registries of each country rape offences in India show 1.8 rapes for every 100,000 versus 28.8 rapes reported for every 100,000 in the United Kingdom:

It is not that the police statistics are necessarily reliable, but that judgments are made based on facts projected in the media, rather than the reality which remains unknown to all. Rapes, murders & mass murders, violent crimes, cyber-crimes, are all substantially higher in the west than in the east. The choice of which facts are highlighted and which are suppressed, ignored, or hidden plays a crucial role in forming our worldview. If newspapers presented arguments and discussions on why police statistics show 15 rapes in England for every one in India, the public would not develop a worldview according to which women are oppressed only in under-developed countries.

Myth #10: Wealth and Freedom are Measures of Development

Suppose someone robs me of all my possessions at gunpoint. Clearly he is more powerful and (now) wealthier than me. Does it follow that he is better than me and worthy of emulation in all respects? This is a logical consequence of the idea that wealth and power are the central characteristics of development. While these are admirable characteristics among barbarians, nearly all civilizations prize other virtues.

Across civilizations, cultures, religions, there is almost universal consensus on the idea that pursuit of wealth is harmful. The Bible states that the "love of money is the root of all evil," and that " it is easier for a camel to go through the eye of a needle than for someone who is rich to enter the kingdom of God". Lao Tzu said "Do not race after riches … or you will let slip the Heaven within you." Similarly Islamic teachings condemn greed, selfishness and hoarding of money, and praise generosity and spending for the sake of Allah. In nearly all societies except for the modern western society, people are praised and honored for character, spirituality, wisdom, heroism, literary, artistic and many other accomplishments, but not for acquisition of wealth by loot and plunder. However, in modern society, wealth trumps all other accomplishments. There are no moral bars to the most powerful country in the world making a naked unprovoked attack on a weaker country, killing one million civilians and destroying the lives of forty million, in order to secure oil supplies and makes profits for the military industrial complex.

Books by Polanyi (2001) and Tawney (1926) detail the strange and twisted story of how it came to pass that the pursuit of wealth went from being an undesirable characteristic to a desirable one. This great transformation has resulted in governments all over the world single-mindedly pursuing the goal of increasing GNP per capita, under the assumption that wealth will solve all problems. It is only recently that a number of spectacular failures have led to a questioning of these assumptions. A recent report by Stiglitz, Sen and Fitoussi (2009) questions the use of GNP per capita as a yardstick for progress on several grounds. Some serious objections to this measure are as follows:

1. GNP measures production but not destruction or depletion. In effect, by using up exhaustible resources, damaging environment beyond repair, destroying species of plants and animals, we are robbing our posterity to create wealth for ourselves. Many authors like Schumacher (2010), Douthwaite (1993), have shown negative accumulation of wealth when costs of growth are properly accounted for.

2. Many intangible social costs are ignored. Worse, if environmental hazards lead to sickness, expenses on medical care are actually add to the GNP. Destruction of communities, stability of families, moral decline, etc. are very important to human welfare, but not accounted for in GNP.
3. Because of these gaps, perceptions of how the economy is doing can differ widely from what official figures suggest. In addition, the Easterlin(2010) paradox shows that huge increases in GNP per capita do not have any effect on happiness/welfare/life satisfaction in the long run. This suggests that we are putting our efforts in the wrong direction in trying to maximize wealth.

In the same way, freedom is highly prized in the West. The French Revolution provoked Hegel to believe that 'the History of the World is none other than the progress of the consciousness of Freedom.' There is no doubt that certain types of freedom are extremely valuable. However, freedom is a plastic word, and can be reshaped to have many different meanings. Should the poor be free to sell their organs to the rich? Pedophiles are currently demanding the freedom to practice their perversion. This is not what Hegel, or other principled advocates of freedom had in mind.

Use of freedom as a defense of capitalism is one of the most egregious abuses of the word. On the surface, "Laissez-Faire" or let everyone do as they please, appears to be a most egalitarian philosophy. All are to be given freedom. The laborers are free to sell their labor for the market wage, and the capitalists are free to earn suitable returns on their wealth. The grossly inequitable nature of this freedom is not immediately apparent. Millions were given the freedom to starve in Irish and Bengal famines so as to preserve the freedom of the markets. Grains guarded by military against hungry mobs were shipped out of Bengal at the height of the famine, because higher prices were available elsewhere.

Freedom for everyone hides the fact that the poor have no choices, while the rich can use their wealth and power to freely exploit the rest. All of the gains from the production are captured by the powerful, while propaganda is used to eliminate the word "exploitation" from textbooks of economics. Piketty & Saez (2003) document the extent of inequality generated by the policy of laissez-faire in USA. Dramatic graphical presentations of the data are available in Gilson & Perot (2011); for instance, the top 0.01% has average income of more than $27 million, while the bottom 99% has only $31,000. Should we blind our eyes to this thousand-fold inequality, and allow all to freely compete in the market? This is exactly the current policy, and the results of this supposed freedom for all results in all of the gains from production going to the already rich – the vacuum cleaner effect (as opposed to trickle-down); Piketty & Saez (2003) show that most of the wealth gains from increased production. are captured by the already.

Economic freedom is ideal if the playing field is level, but when a few are enormously advantaged, then "freedom" is equivalent to freedom of the rich to enslave the poor. The poor have no choices, and cannot take any advantage of their supposed freedom.

Truth #10: Dual Nature of Freedom and Wealth

As Aristotle (1999, Book 1, Chapter 5, N. 8, p. 5) noted: "wealth is not the good we are seeking and is merely useful for the sake of something else." This knowledge was lost in the west. In a secular society, goals of life were left to be determined by individuals, since common social goals could not be agreed upon. In absence of common goals, social agreement was only possible on providing freedom and wealth, as the means to all possible goals. Gradually, failure to prescribe realistic and meaningful life goals at the social level, led to these instruments and means becoming prized and valuable goals. This has led to a social disaster. Although older generations knew and understood this truth, the current generations have completely lost sight of the fact that wealth and freedom *as goals* are deadly, even though both are valuable *as means* to the attainment of meaningful life goals. This apparent paradox is expressed in the Quran as follows:

Q (9:34) They who hoard up gold and silver and spend it not in the way of Allah, unto them give tidings (O Muhammad) of a painful doom.

The hoarding of gold and silver – pursuit of wealth for its own sake – leads to a painful doom. At the same time, spending in the way of Allah is highly prized and encouraged. Wealth acquired for this purpose leads to tremendous rewards. This dual nature of wealth is explained clearly in many different traditions of Islam. For example, Zakariyya (1999, Book 1 Stories of Sahaba, Chapter 9, Section 9) reports that the Prophet Mohammad S.A.W. said:

> Hakim! Wealth has a deceptive appearance. It appears to be very sweet (but it is really not so). It is a blessing when earned with contentment of heart, but there is no satisfaction in it when it is got with greed.

Money can be a blessing, provided that it is obtained and spent for useful purposes, without love of money entering and corrupting the heart. The Quran is full of encouragement to spend money, especially that which is beyond your needs, on others. Curing the disease of the love of money is essential to spiritual and human progress. As the Quran states, spending on others is required to cleanse the heart of the love of wealth, and to purify it.

> *92:18 he that spends his possessions [on others] so that he might grow in purity*

This is in direct contrast with the wisdom of Keynes, currently being pursued with vigor all over the world:

> When the accumulation of wealth is no longer of high social importance, there will be great changes in the code of morals. … we have exalted some of the most distasteful of human qualities into the position of the highest virtues. The love of money as a possession (… is …) a somewhat disgusting morbidity ... But beware! The time for all this is not yet. For at least another hundred years we must pretend to ourselves and to everyone that fair is foul and foul is fair; for foul is useful and fair is not. Avarice and usury and precaution must be our gods for a little longer still. For only they can lead us out of the tunnel of economic necessity into daylight" (Keynes, 1930 cited in Skidelsky, 2001).

Keynes understood that love of money is a disease, but felt that encouraging it would lead to the accumulation of wealth in the society that would eventually solve all human problems. This was a mistaken idea. Wealth does indeed accumulate in the hands of the greedy, but their love of money prevents them from spending on others. The process of accumulation of wealth by greed causes tremendous harm to both society and the planet. Massive amounts of luxury and opulence co-exist with massive amounts of misery and poverty in the world we see around us. The greed of the rich prevents them from using their wealth to help the poor.

Exactly as wealth has a dual nature, so freedom has a dual nature. If used wisely to the pursuit of good ends, it is extremely valuable. If used unwisely to pursue bad goals, it can cause tremendous damage to all. The Quran contains the clear message:

> 33:72 Verily, We did offer the trust [of reason and volition] to the heavens, and the earth, and the mountains: but they refused to bear it because they were afraid of it. Yet man took it up - verily, he has proven to be most wicked, most foolish.[Zamakhshari comments on this verse: "and then failed to measure up to the moral responsibility arising from the reason and the comparative free will with which he has been endowed."] This obviously applies to the human race as such and not necessarily to all of its individuals.

Freedom places a tremendous responsibility on our shoulders – the heavens and the earth shrank from bearing it. This is the responsibility to be wise (have knowledge of the good), and to be virtuous (to act on this knowledge). In general, human beings have failed on both counts. They have been foolish, in failing to learn what is the best course of action, and they have been wicked, in failing to act on the knowledge of the good, even when they had it. Thus, instead of being a blessing, freedom has been the bane of mankind. Those with wealth and power have abused their freedom by using these to exploit the poor and powerless:

30:41 corruption has appeared on land and in the sea as an outcome of what men's hands have wrought

In practice, as noted by many authors, freedom of the rich to pursue wealth, without any social constraints, has translated to their freedom to destroy the planet. Commenting on the interpretation of the Quran 30:41 cited above, the translator Asad (2008) writes:

> Thus, the growing corruption and destruction of our natural environment … is … "an outcome of what men's hands have wrought", …(human) activity … threatens mankind with previously unimaginable ecological disasters: an unbridled pollution of land, air and water through industrial and urban waste, a progressive poisoning of plant and marine life,… and the gradual extinction of many animal species essential to human well-being. To all this may be added the rapid deterioration and decomposition of man's social life, the all-round increase in sexual perversion, crime and violence.

It is certainly possible to use our freedom to the benefit of mankind, but this requires wisdom and virtue.

Myth #11: Wisdom of the West

In Europe, a tremendous battle took place between science and Christianity, with famous highlights being the recantation of Galileo, and the burning of Bruno at the stake. Science won the battle, and sought for itself the sacred status earlier accorded to religious knowledge. The philosophy of logical positivism was invented to show that scientific knowledge was the only knowledge worthy of the name, and all other kinds of knowledge – including religious knowledge – was merely an illusion. This philosophy became widely popular in the early twentieth century, and continues to be extremely influential, even though it was proven wrong around the middle of the twentieth century. The misunderstandings created by this philosophy led the majority of western intellectuals to exclude the most precious and valuable kinds of knowledge from the domain of knowledge itself. The most important type of knowledge is to know what it means to be a human being, to learn the meaning and purpose of life, and to know how to achieve excellence in conduct. Because science could not address them, all of these questions came to be regarded as meaningless questions without any answers. Thus, over the past century, instead of progress, there has been a significant and serious decline of knowledge in the west.

2:257 God is near unto those who have faith, taking them out of deep darkness into the light - whereas near unto those who are bent on denying the truth are the powers of evil that take them out of the light into darkness deep.

Under the influence of logical positivism, western intellectuals came to a nearly unanimous conclusion that "good" and "evil" are meaningless metaphysical concepts. For example, a leading philosopher Ayer (1936) expressed what came to be the consensus view as follows:

> We can now see why it is impossible to find a criterion for determining the validity of ethical judgements … because they have no objective validity whatsoever . . . They are pure expressions of feeling and as such do not come under the category of truth and falsehood. They are unverifiable for the same reason as a cry of pain or a word of command is unverifiable.

Ethics was taken out of the realm of knowledge, and given the reduced status of a feeling, like a cry of pain. The arguments of Nietzsche for going "beyond good and evil" and subsequently Skinner for going "beyond freedom and dignity" came to be widely accepted. As a result, the concept of morality was dropped from Western education in a gradual process spanning the twentieth century; see Reuben (1996) for details. The idea that an education is a means of development in all dimensions: spiritual, social, and human, was gradually forgotten. It was replaced by the idea that education is a means to earn money or acquire job skills. As many critics have come to realize, the educational goal of turning humans into productive cogs in a machine displaces essential knowledge about what it means to be a human being. For instance, Gatto (1998) writes:

> "level, anxious, spiritless families, godless and conforming; people who believe that the difference between Coke and Pepsi is matter worth arguing about. The American economy depends on schooling us that status is purchased and others run our lives. We learn there that sources of joy and accomplishment are external, that the contentment comes with the possessions, seldom from within."

Higher education in the west, just like mass education at lower levels, is no longer designed to produce character development. It was not illiterate savages, but graduates of the finest educational systems of the West who designed the gas chambers used to burn millions of innocent men, women and children in Germany. Julie Reuben (1996) has documented how the efforts to build character were gradually abandoned in western universities in the twentieth century. This has led to a situation where brilliant scientists design weapons which can cause deaths of millions, or fry innocents in heat. Ph.D. physicists who developed the nuclear bomb denied any responsibility for Hiroshima and Nagasaki. Displaying the moral blindness created by this educational system, Oppenheimer's testimony about the effects of the atom bomb before Congress first describes the spectacular light, fire and smoke show that would result, and then turned to the deadly slaughter of all within effective radius (see Valiunas, 2006). David Halberstam (1993) has documented how graduates of Yale and Harvard ran the Vietnam War on the pattern of an efficient business, with callous disregard for human suffering: more than one million civilians died as "collateral damage" in the mass bombings and napalming, and atrocities and massacres were common. Leading biologists work for salaries to develop non-fertile varieties of genetically engineered high yield grains so that multinationals can profit from the hunger of humanity. Profits and wealth trump ethics and morality, as explicitly stated by Milton Friedman, who encouraged businesses to pursue profits and ignore social concerns. Pursuit of these principles in leading business schools has led to a "terrible failure," as the following quote from Harvard Professor Zuboff (2009) indicates:

> "I spent a quarter-century as a professor at the Harvard Business School, including 15 years teaching in the MBA program. I have come to believe that much of what my colleagues and I taught has caused real suffering, suppressed wealth creation, destabilized the world economy, and accelerated the demise of the 20th century capitalism in which the U.S. played the leading role.
> We weren't stupid and we weren't evil. Nevertheless we managed to produce a generation of managers and business professionals that is deeply mistrusted and despised by a majority of people in our society and around the world. This is a terrible failure."

Truth #11: Ignorance Masquerading as Knowledge

Given that we have only one chance to live, what is the most important kind of knowledge? Obviously, we need to know: what is the best way to live our lives? The Quran informs us that demonstration of excellence in conduct is the purpose of the creation of life and death:

67:2 Who hath created life and death that He may try you, which of you is best in conduct;

Because of science replaced religion as sacred knowledge in the west, science was called upon to give answers to deep and difficult questions about what it means to be human, what is the purpose of life, what is excellence in conduct, and suitable rules for social and political organization. The attempt to find scientific answers to these questions was labeled the "Enlightenment Project." Contrary to the hopes of the Enlightenment philosophers, science did not prove to be capable of answering them. Scientists learned how to do heart transplants, but could not learn how to purify the heart of deadly emotions like envy, lust, greed, pride and others. This process, the purification of the heart, is among the central teachings of Islam.

The mistaken idea that scientific knowledge is the only kind of knowledge, and that social science must be patterned on physical science, led to a huge number of misunderstandings, which continue to dominate intellectual discourse in the west. It is impossible to list them all and document these errors, which are built into the foundations of a modern western university education. We can only sketch a few major ones, and indicate why they are wrong.

1. *Misunderstanding Human Beings*. Since science deals with inanimate particles subject to physical laws, the school of behavioral psychology proposed to treat human beings as robots which can be programmed via conditioning. Skinner (1972), the founder of this school, wrote "Beyond Freedom and Dignity," which denied both reason and volition to human beings. This became the dominant school of thought in psychology for most of the twentieth century. Many problems, including the collapse of logical positivism, have led to serious reconsideration and emergence of alternatives, but behavioral psychology continues to command intellectual respect and dominate orthodoxy. In contrast to behavioral psychology, Islam offers deep insights into the nature of human beings, and the sources of satisfaction and well-being. Thousands of US soldiers have converted to Islam after having close encounters with Muslims; see Phillips (1998). Many cite their amazement at the ability of Muslims to cope with extremely difficult and stressful situations on the basis of Islam; see for example, Campbell (2013) . Similarly, psychological teams in post-Earthquake Pakistan found Muslims much better able to cope with deep trauma created by massive personal and social catastrophes.
2. *The Search for Quantifiable, Observable, and Universal Laws*: Since science is based on universal laws, which do not vary by country, culture, or time, social science also attempted to do the same. However, this is impossible. Human behavior is conditioned by particular historical circumstances, and cannot be studied by means of universal laws applicable to all societies at all times. To understand human beings, we must understand the society in which they live, and the particular historical circumstances they face, including their political economic and social environment. Gray (2007, p. 2) writes that "political philosophy … cannot even begin to grapple with the political dilemmas of an age in which political life is dominated by renascent particularisms, militant religions and resurgent ethnicities." Similarly, the stark failure of economists to foresee the massive global financial crisis of 2007-

2008 was blamed on unrealistic mathematical models (imitating the laws of Physics) by many Nobel caliber economists. For example, Krugman (2009) said that the profession of economists as a whole went astray because they mistook the beauty of mathematics for truth. In Zaman (2013) and related writings, I have shown that Islamic teachings offer a far deeper understanding of economic problems of man, and also provide excellent solutions, not within the ambit of contemporary modern economic teachings.

3. *Justice:* When abstractions like ethics and morality were taken out of the realm of knowledge, western intellectuals decided that these were just social conventions. That is, anything that a society agrees to is valid as a conception of justice. In ancient Roman times, opposing parties would be represented by Gladiators, and legal cases would be decided in favor of the party whose champion won the fight. Today, the identical concept of justice prevails, except that gladiators have been replaced by lawyers. As explicitly stated by a panel of lawyers (Stanford Magazine, 1983), the judicial system is adversarial in nature. Both lawyers on opposing sides have the duty to do their best to win the case for their client, regardless of whether or not the outcome will be just. Islam has a radically different concept of justice. The judge and both parties seek to arrive at a solution which is just to all. There is an effort to achieve consensus: all should agree that the solution is just. Thus the system is not necessarily adversarial in nature, though conflicting interpretations of justice may arise.

Historical developments in the west have led to an extremely distorted understanding of the nature of human knowledge. The ability to build an atom bomb is classified as scientific knowledge. The idea that it is wrong to kill innocent men, women and children by bombing entire cities, is not classified as knowledge. This is just a feeling, and normative propositions are not worthy of the name of knowledge. With this disastrously mistaken epistemology, Hiroshima and Nagasaki, the Gulag, and burning alive of millions of innocent Jews and genocides without end become possible.

Myth #12: The Progress of the West

Perhaps the most fundamental myth is that of progress. Over the past few centuries, western civilization has scaled heights hitherto unknown to mankind and reached peaks of excellence. Is this really true? There is no doubt that there has been fantastic progress in science and technology. However, all this progress has been purchased at a huge cost. Does it really count as progress that we have learnt how to fry thousands of innocents (men, women, and children) on burning streets by fire-bombing Dresden and Tokyo? That millions died in senseless world wars in the twentieth century? That the resulting shortage of young men led to a rapid decline in moral standards, which has had the outcome of destroying family life in the west?

The Enlightenment dream was that reason, embodied in achievements of science and technology, would solve all human problems. In particular, they hoped that reason would lead to stronger basis for a better morality than one provided by Christianity. This dream turned into a nightmare in the twentieth century. Nietzche (cited in Glover, 2001) had far greater insight into the consequences of abandonment of religion:

> As the will to truth thus gains self-consciousness - there can be no doubt of that - morality will gradually perish now: this is the great spectacle in a hundred acts reserved for the next two centuries in Europe - the most terrible, most questionable, and perhaps also the most hopeful of all spectacles.

Nietzsche was contemptuous of the ideas of compassion, love, sympathy, humility as being signs of weaknesses. He admired the virtues of the barbarians who triumph over civilizations which become weak through degeneration and luxury. The popular philosophy of Social Darwinism suggested that the human race would improve by extermination of the weak. In line with this philosophy, Nietzsche despised the majority, including most Europeans of his own time. He even says, 'the great majority of men have no right to existence, but are a misfortune to higher men. There are also peoples that are failures.' He celebrated the "Supermen," a small and select group of ruthless leaders, who would 'accept with a good conscience the sacrifice of innumerable men who … have to be suppressed and reduced to imperfect men, to slaves and instruments.'

Does it matter what Nietzsche said or thought more than a century ago? Philosopher and Ethicist Jonathan Glover (2001) thinks so. He devotes to Nietzsche the first chapter of his book "Humanity: A Moral History of the Twentieth Century" which documents many of the extreme atrocities which took place the twentieth century. Glover writes that "Poor answers to {ethical} questions have contributed to a climate in which some of the disasters were made possible." Many have attributed Nazi excesses to the influence of Nietzsche. Recent human disasters, like presidential authorization of torture, and imprisonment of innocent children in western Gulag of Guantanamo Bay, and countless other massacres, are due to people like Nietzsche who think that "To see others suffer does one good, to make others suffer even more. … Without cruelty there is no festival …" As we have stressed earlier, it is ideas which move history. It is certainly true, to paraphrase Macaulay (1958) , that the entire Arabic literature can produce no match for the writings of Machiavelli, Marquis De Sade, Nietzsche, and the Kubark Manual of CIA[2]. Many inhuman ideas have become embedded into the foundations of western thought, and are responsible for a huge amount of human misery that we see around us.

The wonders of science and technology are often cited as proof positive of the progress of the west. There is mounting evidence that these advances may actually destroy the possibility of life on our planet. Diamond (2005) finds that today's global, technologically advanced civilization is very far from solving the problems that plagued primitive, isolated communities in the remote past. Diamond comes close to despair when contemplating the environmental havoc engulfing our rapidly industrializing planet. Technology has created more problems than it has the capability to solve. To take just one example from a long list, Monsanto genetic engineering has caused the emergence of superweeds, wreaking havoc on grain harvests in the USA.

Has all the scientific and technological progress, plus the accumulation of wealth, led to better lives in the West? All evidence points to the opposite: human lives have become progressively impoverished, in many dimensions. Among the most important dimensions of human existence is social contact. Solitary confinement is a form of torture. Today there is an epidemic of loneliness in the west. In recent survey, *The Lonely Society*? by Griffin (2010) of the Mental Health Foundation, about 80% of those surveyed admitted to feeling lonely, and 40% admitted to being depressed due to loneliness. Families have broken down because people marry less, marry late, and marriages don't last very long. Because of this, there has been a tremendous increase in people living alone, and also in people feeling alone while engaged in nominal relationships with others. Survey data from

Wilson & Moulton (2010), details loneliness in America. Edmondson (2010) sums up the striking statistics as follows: "Over 44 million people are lonely and longing to connect with another living, breathing soul. Even sadder is the fact that they are ashamed of their loneliness, and that shame hinders their efforts to meet and bond with another person."

The reasons for this striking rise in loneliness and breakdown of families is simple. Freedom from political, economic and social oppression was made into an over-riding virtue in the western civilization. Later, the meaning of freedom was expanded in directions never intended by the original seekers of freedom. Freedom came to mean freedom from social obligations, from commitments to family and community, and freedom to pursue selfish goals without concern for others. Unfortunately, what people value most is love, friendship, social relationships. Paradoxically, in a society where everyone pursues pleasure selfishly, no one can get the unselfish love from others which gives the maximum amount of satisfaction and happiness.

Truth #12: The Moral Decline of the West

The idea that wealth and power – created by weapons and technology -- are measures of progress is suitable for barbarians intent on loot and pillage, not for the civilized. Islam teaches us that learning how to be human is the measure of progress. Human beings have the potential to be the worst of creation (Asfala Safeleen) and also the best of creation (Ahsane Taqweem). Measured in terms advances in humanity, the west has been declining rather than progressing.

In late nineteenth century, Lord Acton (n.d.) re-iterated the prevailing belief that "Opinions alter, manners change, creeds rise and fall, but the moral law is written on the tablets of eternity." However, Bertrand Russell (1903) captured the spirit of the twentieth century in the following passage:

> That man is the product of causes which had no prevision of the end they were achieving; that his origin, his growth, his hopes and fears, his loves and his beliefs, are but the outcome of accidental collocations of atoms; that no fire, no heroism, no intensity of thought and feeling, can preserve an individual life beyond the grave; that all the labours of the ages, all the devotion, all the inspiration, all the noonday brightness of human genius, are destined to extinction in the vast death of the solar system, and that

> the whole temple of Man's achievement must inevitably be buried beneath the debris of a universe in ruins -- all these things, if not quite beyond dispute, are yet so nearly certain, that no philosophy which rejects them can hope to stand. Only within the scaffolding of these truths, only on the firm foundation of unyielding despair, can the soul's habitation henceforth be safely built.

A natural consequence of the denial of God is this lesson, that all human effort is meaningless. This lesson has been deeply absorbed by secular western societies, and has resulted in tremendous harm. The most important harm has been a loss of understanding of what is the purpose of life? But also, the idea of morality as an internalized value has been replaced by the idea of morality as a social convention. In the 1970's homosexuality was a social evil, a crime, and officially listed as a psychological disease requiring therapy. In the 1990's it became acceptable as a lifestyle choice, gay marriages were legalized, and to speak against homosexuality became a crime. Without religion, there is no foundation for moral beliefs – anything that society agrees to, from torture to child pornography, can become moral. With the loss of the religious anchor, morality has virtually perished in the west, exactly as Nietzsche foresaw. The results have been catastrophic for human beings.

Glover (2001) writes that contrary to Enlightenment expectations that humans were maturing and growing out of their warlike past, "much of twentieth-century history has been a very unpleasant surprise. Technology has made a difference. The decisions of a few people can mean horror and death for hundreds of thousands, even millions, of other people." He documents large numbers of atrocities, such as the British continuation of embargo of food to Germany, after German surrender, which led to death by starvation of about 800,000 Germans.

The cold and calculated burning, in scientifically designed ovens, of millions of innocent Jews – men, women and children --, is a landmark in human history. Bauman's (1989) award winning analysis in "Modernity and the Holocaust" buries the idea that this was an exceptional event due solely to a deviant madman. Rather, he argues that every ingredient of the Holocaust was a normal part of modernity, which has no safeguards against recurrences. In a secular democracy, morality is created by the majority, and not subject to external validation. If reason leads the majority to the conclusion that extermination of a recalcitrant minority is the most efficient route to progress, modernity poses no barriers to the implementation of this Final Solution. Bauman shows that the extermination of the Jews occurred with the knowledge and tacit compliance of the majority of the population. Similarly, such final solutions have often been inflicted on inferior races outside of Europe without attracting attention. More recently, the "Shock and Awe" strategy was explicitly designed to terrorize Iraqi's into complete submission to the US. To achieve this goal, hospitals, schools, power and water infrastructure, cultural landmarks, and libraries were deliberately destroyed, in order to create terror in the hearts of the population. These rational calculations which killed more than a million and destroyed the lives of the remaining forty million could not have been contemplated in a civilized society.

There are two major sources of moral training for the younger generations: family and school. As Reuben (1996) has documented, the idea of character building and training in civic duties was explicitly dropped from goals of a university education over the course of the twentieth century. Similarly, breakdown of the family in the west has destroyed the other basis for moral education. Center for Social Justice (2006) reports in "Fractured Families":

> This Report paints a worrying picture of family breakdown in the UK. We now have one of the highest divorce rates in the Western world and the fabric of family life has been stripped away in the past thirty years. This study also shows more clearly than ever the destructive effects of family breakdown upon millions of children, as well as the links between family breakdown and addictions, educational failure and serious personal debt.

With no sources of moral guidance, it is small wonder that 75% of the students were caught cheating recently in a large undergraduate course at Harvard – see Carmichael (2012). There are many indicators that the young generation has lost its moral bearings completely. A recent Josephson Institute (2008) survey showed rates well over 30% of theft, cheating, and lying among high school teenagers in 2008. What is worse, the vast majority did not find anything wrong with such behavior.

Not only is there lack of guidance, but there is active effort by the media to misguide people regarding morality. In a phenomenon which picked up steam in the 1970's movies increasingly started to portray immoral behavior as normal. Today, movies have heroes and heroines who are paid assassins, criminals, savage brutes, thieves, prostitutes, torturers and murderers. Perhaps as a consequence, USA has the world's largest prison population in real numbers, 2.3 million people behind bars. Liptak (2008) reports that with 5% of the world population, the US has 25% of the world's prisoners. Solnit (2013) reports a rape a minute and a thousand corpses due to violence by an intimate partner every year. There are increasing incidents of mass murders and shooting sprees, by people who apparently derive pleasure from killing. This can hardly be unexpected in a society where the average child watches 8000 murders and 100,000 acts of violence (Anderson, n.d.), and play computer games teaching them to enjoy killing random strangers and watching the blood flow.

And this is called progress, and civilization.

Conclusions

The teachings of Islam transformed a barbaric and ignorant population of Arabs into standard bearers of morality, who lit the torch which guided mankind for a thousand years. What Islam gave to mankind has been documented by many historians, including Syed Abul Hassan Ali Nadvi (2005) in his classic work "Islam and the West" which been translated into more than thirty languages. The Bible prophesies that the message to be brought by Prophet Mohammad S.A.W. (referred to as the Spirit of Truth) is too powerful to be borne by the companions of Jesus:

John 16:12-13: I have much more to say to you, more than you can now bear. But when he, the Spirit of truth, comes, he will guide you into all truth.

The standards of excellence that Islam sets are outside the ambit of western conceptions. The Quran states that within human being lies the potential to rise above the angels, and encourages us to struggle to realize this potential for excellence. It also provides us with guidance on how to carry out this struggle.

Islam asks us to be fair, even to enemies:

Q5:8 O ye who believe! stand out firmly for Allah, as witnesses to fair dealing, and let not the hatred of others to you make you swerve to wrong and depart from justice. Be just: that is next to piety: and fear Allah. For Allah is well-acquainted with all that ye do.

In obedience to this command, Salahuddin Ayubi did not take revenge on the crusaders who had slaughtered all civilians and prisoners when he recaptured Jerusalem. Many Muslim conquerors have followed the shining example of the Prophet, and forgiven enemies, in stark contrast to the European maxim that "All is fair in love and war."

In the siege of Edirne during the First Balkan War (March 1913) even in dire circumstances with compelling necessity, the ruling of Islamic law that the property of the non-Muslims could not be seized for purposes of defence was obeyed punctiliously by Muslims under siege. This is in stark contrast with USA's seizure and placement of civilian Japanese in concentration camps during World War 1.

Islam has extremely high standards of justice:

Q4:135 O ye who believe! stand out firmly for justice, as witnesses to Allah, even as against yourselves, or your parents, or your kin, and whether it be (against) rich or poor: for Allah can best protect both. Follow not the lusts (of your hearts), lest ye swerve, and if ye distort (justice) or decline to do justice, verily Allah is well- acquainted with all that ye do.

Throughout history, we can find examples of Muslims who have followed these teachings and borne witness against themselves and their own kin or communities, in the interests of justice. This is in stark contrast with the idea that this is beyond human capabilities, and hence the Fifth Amendment allows people to refuse to testify against their own selves.

Islam has extremely high standards for generosity:

Not only should spend on others, but we should give the best of what we have:

3:92 never shall you attain to true piety unless you spend on others out of what you cherish yourselves; and whatever you spend - verily, God has full knowledge thereof.

The Quran praises those who give to others, even though they are themselves in need:

59:9 (They prefer the refugees) above themselves though poverty become their lot. And whoso is saved from his own avarice such are they who are successful.

This is in stark contrast to western teachings that self-interest can and does dominate human motivations.

Islam has extremely high standards for Compassion

The Prophet Mohammad S.A.W. was sent as a Mercy for all Mankind. He embodied excellence in conduct, and provides a perfect model for us to follow. He cared deeply for all human beings, whether Muslims or not, and took their sorrows for his own

9:128 INDEED, there has come unto you [O mankind] an Apostle from among yourselves: heavily weighs -upon him [the thought] that you might suffer [in the life to come]; full of concern for you [is he, and] full of compassion and mercy towards the believers

Those trained in western intellectual traditions have an immediate problem with a listing of normative ideals like the one provided above. What does this list mean? What matters is whether or not these norms translated into actual behavior. Do Muslims actually adhere to these standards of excellence?

Methodological Differences between Islam and Social Science

These questions arise due to the fundamental mistake of confusing social science with physical science. Indeed in the physical sciences our goal is to describe, and the normative has no role to play. However the Islamic methodology for social science is radically different, as it ought to be. First we describe a goal, which is the highest standard of excellence. Then we motivate human beings to strive for these goals. There is no expectation that all will come up to these standards at all times. Indeed it is understood from the outset that these standards are beyond our reach – no one can actually match the excellence of our prophet Mohammad S.A.W. Just like the North Star sets that the direction for sailing, without being attainable, so these standards set the direction for our struggles. There is explicit recognition that not all will meet these standards. Thus it is said in Hadeeth that excellence is to return an evil with a favor. If this is not possible for us, then we should try to forgive the evil done to us. If even this is not possible, then it is permissible to take revenge, but in no case should the revenge exceed the harm done to us. Thus three levels of acceptable conduct, ranging from excellent to good to average are described.

The second major difference with western social science is that Islam is strongly focused on the struggle for excellence, and not on the outcome of this struggle. Allah T'aala promises us that those who struggle will be guided to His pathways:

29:69 And those who strive in Our (cause),- We will certainly guide them to our Paths: For verily Allah is with those who do right.

The idea of the "Invisible Hand," that people can act selfishly but achieve socially beneficial outcomes makes no sense at all in terms of Islamic ideals. This is because generosity and unselfish behavior is itself the goal of Islamic teachings. Only those who are saved from the avarice which is present within the human soul are the ones who are successful. People who give to others out of selfish motives such as gaining a good reputation will be condemned to the hellfire. A more complete discussion of Islamic methodology for economics, and ten dimensions of contrast with western methodology is given in Zaman (2013) "Re-Defining Islamic Economics".

Final Words

It was prophesied in the Hadeeth that Islam came as a stranger, and it will again become a stranger. This prophecy has come true. Today none of the teachings of Islam are reflected in the collective lives of the Muslims. Islam has distinctive systems of governance, justice, education, trade, markets, welfare, and social norms. In each of these dimensions, Islamic societies are not only following western patterns, but advocating the adoption of western patterns as the solution to our current ills. These western patterns are often strikingly similar to the patterns of the Jahiliyya that existed before the advent of Islam. Islam brought a revolution to the world fourteen hundred years ago, and it has exactly the same revolutionary potential today. The challenge for us Muslims is to realize this potential by translating the teachings of Islam from the books into our lives. May Allah grant us the capability to participate in the struggle for the good that has been enjoined upon the Muslims. Ameen.

Endnotes

1 Personal conversations with Dr. Ali Khan of Johns Hopkins, in which he discussed this event.

2 Alfred McCoy (2007) has documented the evolution of the European tradition of torture of heretics (including Muslims and Jews), which started with the Spanish Inquisition. He describes the CIA manual for torture (The Kubark Manual) as "the first real revolution in the cruel science of pain in more than three centuries." This manual describes techniques developed by 'scientific' research on mental patients funded by the CIA. These methods, used in Al-Gharaib and Guantanamo Bay, are in stark contrast with Islamic rules for Jihad.

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Methodological Discussion on the Subject of Islamic Economics

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Abstract

While the number of studies and controversial debates on the reliability of Islamic economics has recently experienced a sharp rise in number, the methodological inquiry and appraisal of Islamic economics has become more important than ever before with regard to the improvement of the scientific methodology of the field and to ensure that it moves forward in a more appropriate direction. This paper attempts to scrutinize widely applied methodological perspectives in Islamic economics; namely Usul-al Fiqh, Islamization of Knowledge, Maqasid al-Shariah and Tawhidic Methodology. Finally, a more holistic methodological approach as proposed in Islamic economics entitled the Methodology of the Economics of Islam will be presented. Through this methodology, religious variables have been suggested that can be interlinked with economic attitudes for improving the spiritual perspective of the field and explaining economic realities in a more suitable way.

Key Words: *Methodology, Islamic economics, Usul al-Fiqh, Typology*

Introduction

With the onset and spread of the recent global financial crisis, an increase in the number of fiery debates on the methodology of Economics can be observed. A myriad of remedies emanating from methodological alternative approaches have been suggested by opposing mainstream ideas to correct the direction of the field of Economics. Despite such failure

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in the conventional finance system, with the subsequent downsizing of the world economy, there has occurred a sharp growth and rapid development in Islamic Finance industry which stands at around 20 percent of the world financial system annually, a rise from $ 150 Billion in 1990s to $ 1.3 Trillion in 2012. Thus, Islamic economics and Finance have attracted the attention of even non-Muslim religious leaders, high-ranking bureaucrats, well-known multinational investors and international organizations who have begun to consider its potential to provide a solution for the global financial system, an investment opportunity or simply as an 'elephant in the room'-a player too big to ignore.

On the other hand, the contemporary Islamic Finance industry as a sub-branch of Islamic economics with its quasi-western institutions and financial instruments have triggered continuous discussions among Muslims as to whether the essential axioms and fundamentals of Islamic economics and Islamic Finance are underpinned to an appropriate methodology or not. Therefore, the need to shed light on the methodological inquiry of Islamic economics and proposing an appropriate approach have become more crucial and necessary than they ever were before.

From a historical perspective, a central idea has prevailed that the collapse of the Ottoman Empire and the European Colonialism of Islamic Countries caused the intellectual stagnation of Islamic Civilization in the entire world in the subject of Economics as well as in other social studies through the resulting cultural and institutional hegemony of Western Civilizations (Zaman, 2012). As a consequence of the dissolution of colonial empires and the resulting declaration of independence in Islamic Countries one by one, especially in Middle East and South Asia during the middle of 20th century, many of those countries have attempted to establish Islamic frameworks at juristic, economic, and political levels of governments as a reflection of embracing the implications of Islam in social matters on governmental level.

Although there has been reached a consensus among both Muslim economists and Ulamā to establish a usury-free economic and financial system, there have been wide range of views on the scope of Islamic economics, its definition and its methodology on knowledge can be produced in the context of the disintegration of Islamic countries. However, such discussions have mostly remained of a limited scope in terms of lack of a comprehensive methodological inquiry and an indifference towards the addressing of major social and economic problems. To illustrate, current practices of Islamic economics have not gone much beyond the injection of zakah and exclusion of riba into the western economic system through the convergence of most of its applications with versions of applications already existing in western economic system..

During the post-colonial period, some leaders of Islamic countries have strived to maintain cultural and institutional hegemony independent of the influence of European Countries and the USSR disconnecting themselves from their heritage rooted in Islamic Civilizations and have maintained low level of economic and political interaction and integration. Those factors have diminished the pace of methodological improvement in Islamic economics which has yet to reach a satisfactory level according to some scholars (Çızakça, 2011).

The progress of Islamic economics has stagnated with the dissolution of the Ottoman Empire while rapid development in mainstream economics has continued in Western World. Therefore, as a fundamental requirement for restoring the gap in the field, it has been reattempted to establish the discipline of Islamic economics from the dust with the aim of developing the subject from its fundamental axioms to an advanced level.

During the initial efforts for reviving Islamic economics, launching an interest-free economic system has been highlighted as the main concern (Al-Tiby, 2011). Therefore, the field of Islamic economics and its methodology has proven more akin to the relationship between Fiqh and Usul-al Fiqh with initial attempts of isolation from the principles incompatible with Shariah (Al-Sadr, 1983). However, reckoning Islamic economics as a sub-branch of Fiqh by turning it into completely a normative and legal discipline may overlook measuring realities and hence, may undermine instituting suitable economic policies due to a lack of consistent economic forecasting.

On the other hand, the "Islamization of Economics" method has been proposed and applied in the majority of Islamic Countries with view to accelerating the improvement of Islamic economics as well as being able to link doctrinal and scientific issues. However, the problems underlying the epistemological roots of Islamized Economics and the shallowness in normative perspective have rendered the requirement of more holistic methodologies with the inclusion of Maqasid al Shariah and the concept of Tawhid referring to divine unity in all aspects of Islamic economics.

The purpose of this paper is to provide a methodological inquiry and appraisal in detail to diagnose the shortcomings of current methodological approaches of Islamic economics as the consequence of it being a new discipline. Moreover, the paper also attempts to propose a more holistic methodology which interlinks spiritual notions and economic attitudes. Integrating religious elements into Islamic economics could enable the field to progress in a more plausible direction by emphasizing the spiritual side of individuals and society more explicitly.

Usul al-Fiqh Methodology

Fiqh, which means "Islamic Jurisprudence," is, in short, extracted from the sources of the Quran and Sunnah through the method of Ijma and Analogy to be utilized as the guidance for judging a wide range of cases and situations through a Shariah perspective. Moreover, there are myriad of Islamic ruling for pecuniary matters such as transactions, debts and trade categorized as prohibition (haraam), obligation (wajib), recommendation (mandūb) disliked (makrūh) and neutral cases (mubah) under the field of Fiqh. Therefore, any attempt to establish Islamic economics firstly underlies the Shariah's guidance on certain economic and social activities which initially may cause Islamic economics to be considered under the legal notion (Al-Sadr, 1983).

Some scholars assert that Islamic economics is largely and fundamentally based on Fiqh by considering it as a modern juristic interpretation derived from Quran and Sunnah for economic and social activities as a subfield of Fiqh al-Muamalat (Yalçıntaş, 1987). Furthermore, Fiqh al-Muamalat is regarded as being the most essential heritage and basis for the construction of contemporary Islamic economics through its scope in proposing both theoretical and practical solutions for economic activities. Similarly, Islamic economics is also considered to be generated through drawing on Islamic Law to replace the non-permissible with the permissible in secular theoretical structures (Addas, 2008).

Under such legal perspectives, Fiqh has rendered greater more influence on Islamic economics than any alternative perspectives. Nevertheless, it offers limited scope in defining Islamic economics because of an underestimation of the need to the apply scientific methods in the field. This has led to the use of fiqh as being accused of constituting a vain attempt to develop a so-called discipline we might entitle Islamic economics (Al-Sadr, 1983). However, restraining Islamic economics in a legal perspective does not correspond with the spirit of Islam. Fiqh is only one field derived from Quran and Sunnah and has a purpose of providing legal guidance to religious practices, behaviors and activities under certain circumstances.

Moreover, a positivist approach to Islamic economics may also assist in the description of economic and social realities to which appropriate fiscal and monetary policies may be applied for the well-being of a society. Islam pays special attention to rights of labor, ecological balance, education and security. Therefore, applying quantitative research to measure efficiency in investment and the developmental level of each factor in determining the correct and proper rate of taxes and budget spending in the above-mentioned mentioned areas might prove very beneficial in achieving the sustainable development of society.

Although rules in Fiqh have been adopted as the essential guidance for the establishment of normative statements in Islamic economics, overlooking Maqasid al-Shariah may also lead to certain limitations with regard to the proper development in the field of Islamic economics since it concerns main objectives of Shariah which it aims to achieve. Concentration on the main goals of Shariah through exercising a greater concern towards circumstances in contemporary life may enable to eliminate the most crucial social problems regarding Islamic economics.

Islamization of Economics Methodology

After scrutinizing the Quran and Sunnah cautiously, it has been established that both the principal resources in Islam consist of a myriad of descriptive statements in addition to normative statements (Zarqa, 2003). Therefore, it has been suggested that Islamic economics should link practical realities with the doctrine established using scientific methods (Furqani & Haneef, 2012). Thus, Usul al-Fiqh methodology could be considered as a narrow approach due to the reduction of Islamic economics to a pure normative and legal perspective.

The *Islamisation of Economics* methodology has developed as a sub-branch of the *Islamisation of Knowledge* project. This attempts to Islamize relatively more advanced mainstream economics rather than constructing Islamic economics from scratch. This methodology *has been embraced* by many scholars due to the present relative backwardness of Islamic economics and underscores the urgent need to establish an advanced Islamic economic system (Furqani & Haneef,2012).

The plan for the *Islamisation of Knowledge* was initially proposed by Ismail Raji Al-Faruqi through the following of a number of steps: the mastery of modern disciplines, the detailed survey of disciplines, the mastery of islamic legacy with anthologies and analysis, establishment of the specific relevance of Islam to the disciplines, critical assessment of the modern discipline and critical assessment of the Islamic legacy (Al-Faruqi, 1982). This is achieved through isolation of Western elements contradicting with the Shariah and infusion of Islamic elements and key concepts. (Al-Attas, 1993) According to Monzer Kahf, the task of Islamisation is performed simply through takhliyah (taking out the incorrect) and tahliyah (adding in the good) (Kahf, 2008). Al-Faruqi states that Islamised knowledge is "The (pouring of) new knowledge into the corpus of the Islamic legacy by elimination, amending , reinterpreting and adapting its component as the worldview of Islam and its values dictate" (Al-Faruqi, 1988).

Rising disintegration between the subjects of Economics and the Shariah in the recent century has led to independent development in both fields. Hence, lack of expertise, both in the disciplines of Economics and the Shariah, caused economists to produce knowledge based on Western modernist discourse in mainstream economics while Shariah scholars have been tasked with testing knowledge's compliance with Shariah.

Contemporary economics is based on a post-enlightenment materialistic worldview rather than being a value-free and unbiased discipline based on science as it is claimed (Butt, 1989). Although Islamization of Economics is a method of applying Islamic rules and injunctions to secular economics through eliminating western values to make it compatible with Fiqh, applying conventional methodology can still limit Islamic economics into being little more than the worldview and epistemology of conventional economics and hence, induces Islamic economics to become a sub-branch of neo-classical economics rather than being a distinctly pure Islamic model (that might serve) as a better alternative (Zaman, 2012).

Although the *Methodology of the Islamisation of Economics* y fills the gap to restore the advancement of the discipline after its previous ongoing stagnation, it has certain limitations as regard the lack of established distinct theories and practices inspired by Islamic epistemological principles and the heritage of Islamic Civilizations. Additionally, Maqasid al Shariah is in general overlooked due to its narrow focus on fiqh-adjusted secular economics. Similarly, it ignores in taking a spiritual and normative position due to methodological concerns of mainstream economy that tries to explain "what is" rather than "what ought to be". Therefore, scholars have attempted more comprehensive approaches to broaden the scope of Islamic economics with the goal of to altering its future direction and by bringing it in-line with an Islamic vision and associated values.

Maqasid Al-Shariah and Tawhidic Methodology

Maqasid Al-Shariah refers to the purpose and the wisdom behind the enactment of all or most of the Shariah ruling. Utilizing Fiqh only as a filter for measuring the Shariah compliance of Islamic economics might lead to the failure in achieving the fundamental goals of Shariah. That is because Fiqh in general is a tool to rule certain actions or circumstances related to an individual rather than prioritizing existence of certain circumstances in society for the benefit of the masses.

Applying *Maqasid al-Shariah* could prove to be a solution for developing the normative aspects of Islamic economics, yet taking *Maqasid al Shariah* into account as the only determinant factor may lead to several pitfalls during the reshaping of the field of Islamic economics. First of all, as is also valid for *Usul al-Fiqh* Methodology, applying *Maqasid al-Shariah* Methodology might again disconnect the link between the doctrine and the reality. Secondly, Maqasid al Shariah and its tools to achieve its objectives should be dynamic by reinterpreting ever-changing circumstances in contemporary life rather than being static by attempting to achieve same objectives with same means in all Muslim communities with no regard to the necessities of the time and locale. Thirdly, Maqasid al-Shariah is not referring to objectives of Islam, but the objectives of Islamic Jurisprudence (Addas, 2008). Hence, concentrating only on the objectives of Shariah could undermine the achievement of the spiritual objectives of Islam through its exclusion from the methodology of Islamic economics.

Many scholars in Islamic economics have suggested the integration of both positive and normative statements in Islamic economics based on Islamic epistemological principles (Choudhury, 1995). In that context, Tawhidic Methodology attempts to unify economic realities, doctrine and practical experiences, ideals and facts, normative and positive aspects in Islamic economics. It suggests the establishment of axioms of Islamic economics on Islamic principles, determining its social, spiritual and material objectives and applying suitable Islamic policy instruments (Furqani & Haneef, 2012). Although Tawhidic Methodology highlights obstacles in the methodologies of both Islamization of Economics and pure Fiqh related methodologies, it does not explain explicitly how to integrate positive and normative dimensions of Islamic economics.

Economics of Islam Methodology

Economics of Islam Methodology deals with how religiosity in Islam affects the behaviors of individuals, society and economic attitudes as well as measuring what impact economic activities have on the religiosity of Muslims. In other words, *Economics of Islam Methodology* consists of the religious consequences of economic attitudes and the economic results of religious attitudes, which is an analysis of the interaction between religious and economic indicators.

Islam itself puts huge emphasis in both the Quran and Sunnah on impacts of belief on a person's behaviours as well as the impacts of behaviour on his or her religiosity. To illustrate such a relation, "doing good deeds" has been mentioned just after "to believe" in a large number of verses in the Quran. The same may be said for "praying" and "giving zakah" to emphasize the necessary concomitance between belief and actions. In addition, about measuring religiosity with certain behaviors, it is narrated in a hadith;

"Faith has over seventy branches or over sixty branches, the most excellent of which is the declaration that there is no god but Allah, and the humblest of which is the removal of what is injurious from the path: and modesty is the branch of faith." (Muslim, Faith 58)

More specifically, economic attitudes can be considered as subbranch of overall behaviors of an individual and such attitudes are also supposed to have strong relations with religiosity according to Islam. For instance, to indicate the interlink between religiosity and economic attitudes of a person, it is mentioned in a verse in Quran;

"And why do you not spend in the cause of Allah, while to Allah belongs the heritage of the heavens and the earth? Not equal among you are those who spent before the conquest [of Makkah] and fought [and those who did so after it]. Those are greater in degree than they who spent afterwards and fought. But to all Allah has promised the best [reward]. And Allah, with what you do, is Acquainted."(Al-Hadid 10)

What is more, one group of people deserving zakah mentioned in the 60th verse of Surah Al-Tawbah is Al-Mu'allafatu Qulūbuhum which refers to non-Muslims who are sympathetic to embracing Islam. For instance, the Prophet of Allah gave something to Safwan bin Umayyah from the war spoils of Hunayn, even though he attended it while being a Mushrik. Safwan said, "He kept giving to me until he became the dearest person to me after he had been the most hated person to me." (Ibn Kather, 2000). As instructed through a descriptive statement in Holy Quran, this event also provides practical evidence that economic attitudes might influence the religiosity of a person.

Although many descriptive statements in Quran and Sunnah suggest the existence of an observable relation between religiosity and economic attitudes; religiosity as a term should not be directly defined only by attitudes of a person but also by other metaphysical indicators such as trust, justice, prudency and altruism. However, those indicators might again be attempted to be measured by observations of related human behaviors (Tan & Vodel, 2005). After evaluating behaviors to measure metaphysical variables, such variables again might be utilized for investigating their economic consequences. (Dearmon & Grier, 2011). However, measuring the relation between religiosity and economic attitudes 'precisely' by quantitative researches might run into difficulties because explaining metaphysical realities is not completely confined to behaviors of individuals. Moreover, religiosity and economic indicators cannot be always considered as interlinked since the Quran mentions that the distribution of wealth has nothing to do with religiosity;

"Allah extends provision for whom He wills and restricts [it]."(Ar-Rad 26)

To summarize, there are descriptive statements in Quran and Sunnah about the interlinking between religious and economic attitudes. Although it is usual to have strong relations between religiosity and economic attitudes, it is also highlighted that having such a relation is not necessary.

Additionally, religiosity can be redefined in differently ways among various madhab sects, groups or Islamic revivalists. As an example, while Malāmatiyya ūfī understanding in ūfism supports striving in commercial activities without getting distracted from the remembrance of Allah, Batiniyya interpretation of ūfism suggests staying away from doing business in order not to be involved in worldliness which may end up with neglecting spiritual needs (Ülgener, 2006). Therefore, correlation between religiosity and economic activities may indicate a noteworthy gap between communities embracing different interpretations of Islam.

Conclusion

Attempts to rectify methodological underdevelopment in Islamic economics have resulted in several distinct discourses such as Usul al-Fiqh, Islamization of Economics, Maqasid al-Shariah and Tawhidic Methodology.

The theoretical framework and practical applications of each methodology has been discussed in detail through the evolutionary development of methodological debates in Islamic economics. Each methodology has certain limitations on account of a lack of linkages between positive and normative statements, inappropriate epistemological roots, and narrow legal approaches. Therefore, proposing a more holistic methodology renders itself necessary for the development of Islamic economics in a more productive direction.

The *Economics of Islam Methodology* attempts to interlink positive and normative aspects by explaining *the* relation between religiosity and economic attitudes based on epistemological principles of Islam. Such a methodological approach may explain the economic consequences of some metaphysical determinants, and in turn help scholars to understand economic realities in a more comprehensive way. More importantly, taking spiritual variables into account has been so far overlooked in *Methodology of Islamic economics*. Therefore, economics of Islam methodology can assist in the proper integration of spiritual objectives into daily economic activities. This practical implementation may direct each individual, the society as a whole and the state to proper economic attitudes and policies, hence achieve the spiritual objectives set forth by Islamic principles.

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Liquidity Risk Management in Islamic Banks: A Survey

Sabri Mohammad*

Abstract

One of the most important functions of banks is the transformation of maturities, i.e. the ability to obtain funding from short term deposits so as to finance loans over a longer term. As a result of such behaviour, banks are exposed to liquidity risk. Liquidity risk occurs when a bank is unable to cover its financial obligation when it is due without bearing any costs. Hence, liquidity risk management can be defined as a regular process to guarantee that the expected and unexpected cash needs can be met at reasonable costs. While, on the liability side, liquidity risk arises when depositors withdraw their money at once or in large amounts, on the asset side, banks are vulnerable to liquidity risk if the demand in loans increases. Hence, this research provides an overview of the authentic principles of the Shari'ah and the main guidelines of Islamic finance with relation to liquidity risk. In addition, attention is focused on the undertaking of specific techniques and policies as well as the initiation special types of supervision to provide high-quality services so as to satisfy the spiritual and objectives of Islamic finance and subsequently to develop a better understanding of liquidity risk management.

Key Words: *Liquidity risk, Liquidity risk management, Islamic banking and finance*

Introduction

One of the most essential functions of banks is the transformation of maturities; in other words, the capability to acquire funding from short term deposits in order to finance loans at a longer term. As a result, banks

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are susceptible to an inherent liquidity risk (Berger and Bouwman, 2009). Furthermore, due to a number of changes and developments in the financial market, such as the growing use of multifaceted financial instruments by huge financial institutions in a highly competitive manner and the globalisation of the financial market in an increasingly critical atmosphere, the banking sector faced severe challenges related to liquidity risk management in banking sector.

In the financial system, banks' liquidity can be categorised into two types: funding (or liability) liquidity risk and market (or asset) liquidity risk. While, market-liquidity risk is related to the banks' inability to easily counterbalance or sell assets at the market price as a result of inadequate market strength or market distraction, funding-liquidity risk associated to the risk whereby the bank is not able to meet efficiently its obligations as they become due (Basel Committee, 2008). In fact, most banks failures, whether they are Islamic or conventional, are due to the difficulties in managing their liquidity needs (Abdul Majed, 2003).

Islamic banking has grown widely over the last thirty years all over the world through the emergence of an ever-increasing number of banks, branches, accounts and the amount of capital that is invested (Khan, 2010). Good testimony supporting this claim is that many international conventional financial institutions such as Citigroup, ABN Amro, Bank of America, Standard Chartered, Union Bank of Switzerland, HSBC, JP Morgan, Barclays, Kleinwort Benson, Deutsche Bank and Lloyds TSB are now offering Islamic finance services through their Islamic windows. Consequently, the Islamic financial industry has become an essential player in the global financial market. Furthermore, since 1999 both the Dow Jones and FTSE provide specialised indices for *Shari'ah* compliant activities since 1999 (Khan, 2010; Aggarwal and Yousef, 2000). Thus, it can be stated with conviction that Islamic banking is considered considered as one of the fastest developing industries, with a growth rate that doubles every passing year.

According to the latest data from Global Islamic Finance Report GIFR (2012), the actual global size of Islamic financial services industry stands at US$ 1.357 trillion (see table 1) with a growth rate of 25 %. However, the potential global size of Islamic financial service industry is calculated at US$ 4 trillion growing at 10 % (GIFR, 2010). Such a difference between the actual size and the potential one can be attributed to either a misunderstanding of the real meaning of Islamic financial principles or an imperfect implication of these principles in the investment activities of Islamic financial institutions. Such attitudes may lessen the confidence of customers in Islamic banks, and hence, hamper the efforts of Islamic financial industry to reach the size that is potentially feasible.

Table 1: Size of the Islamic Financial Industry

Country	2007	2008	2009	2010	2011
Iran	235	293	369	406	413
Saudi Arabia	92	128	161	177	205
Malaysia	67	87	109	120	131
UAE	49	84	106	116	118
Kuwait	63	68	85	94	95
Bahrain	37	46	58	64	65
Qatar	21	28	35	38	47
UK	18	19	24	27	33
Turkey	16	18	22	25	35
Bangladesh	6	8	9	10	13
Sudan	5	7	9	10	11
Egypt	6	6	8	9	12
Pakistan	6	5	6	7	12
Jordan	3	5	6	6	11
Syria	1	4	5	5	5
Iraq	--	4	5	5	9
Indonesia	3	3	4	5	9
Brunei	3	3	4	4	8
Other Countries	7	7	9	10	125
Total	639	822	1036	1139	1357

Source: GIFR (2012)

It is estimated, optimistically, that Islamic finance will account for 50% of all banking assets within next 10 years in Islamic counties (Farhani and Dastan, 2013; GIFR, 2010). Although the Islamic finance industry is still in its infancy and not as competitive as its conventional counterparts, the customer's desire to conduct their business in accordance with their own beliefs (GIFR, 2010) and the dramatic increases in crude oil prices over recent years were cited as the main factors behind the significant growth of Islamic finance industry in the Middle East (Khan, 2010) in general and in the GCC region in particular.

Presently there are more than 614 Islamic banks and financial institutions in more than 75 countries (Farhani and Dastan 2013: 157; Khan, 2010). 420 institutions are offering Islamic exclusively Islamic financial services and the remaining 194 are conventional institutions having Islamic windows. Over the past two to three years alone, more than 50 Islamic financial service institutions have been launched globally. In particular, the Middle East has witnessed an explosion in the number of Islamic financial service institutions. Islamic financial institutions account for 15% of the Middle East top 30 banks' assets (GIFR, 2010). Furthermore, the GCC Islamic financial market represents 39.05% of the total Islamic financial industry worldwide (GIFR, 2012). According to Khan (2010), Islamic banking and the accompanying finance sector have strongly demonstrated their transformation from a form of ambiguous financial experimentation to a key player in global finance market.

However, like their conventional counterparts, Islamic banks face different types of risks that come as a result of recent changes and developments in the financial market combined with a critical atmosphere and severe key challenges that gained prominence after the recent financial crisis (2007-2009). Moreover, as a result of the unique and complex nature of Islamic financial products, Islamic Banks have been confronted head-on with very different types of risks when compared with those that conventional banks have encountered.

In the banking sector, the transformation of short-term liabilities to long-term assets on the balance sheet is one of the most crucial characteristics in banking that may lead to a liquidity risk for banks (Berger and Bouwman, 2009; Diamond, 2007; Diamond and Dybvig, 1983 and Bryant, 1980). As a result of such functions, banks, whether Islamic or conventional, are exposed to liquidity risk, where banks may experience the harshness of the costs of liquidating their assets so as to cover the liquidity requirements of customers (Berger and Bouwman, 2009; Allen and Gale 2004; Allen and Santomero, 1998). All depositors trust that the bank will pay their deposits back whenever they demand it. However, in the event of any difficulty in response to the desire to withdraw deposits, the bank's reputation will consequently be placed under question. This might well lead to a massive desertion of the bank's customers and a resulting 'run on the bank'. Furthermore, in the case of a 'run on the bank', this might cause incomparable harm to the perceived solidity of the entire financial system of a country.

The anxiety over liquidity risk is more severe with regard to Islamic banks on account of the specific nature of Islamic financial products and activities and also due to the restricted accessibility of *Shari'ah* compatible money market instruments and '*lender-of-last-resort*' (LOLR) facilities (Dusuki, 2007). Accordingly, Islamic banks may face a more critical and wider mismatch between its assets and liabilities. Hence, it is a key challenge for Islamic banks to ensure their ability to obtain adequate funds to offset such mismatch on their balance sheets. However, looking at the issue from another perspective, attaining or upholding a massive sum of liquid funds to evade liquidity risk, would positively increase the costs and negatively affect the effectiveness of the bank to enhance their profitability (Dusuki, 2007). By considering such consequences, the principal challenges towards maintaining an equilibrium consists of key factors such as the safety and profitability of transactions, as well as the compliance with *Shari'ah* concepts in banking operations. The latter represents the core concern of the liquidity risk management in Islamic banking sector.

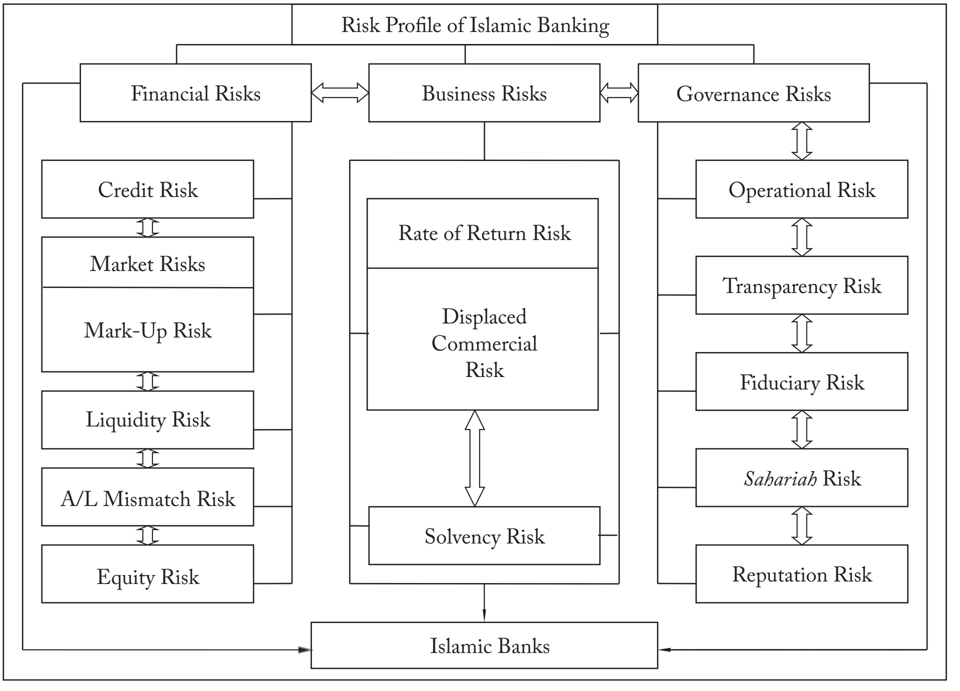
Hence, it is crucial to understand the authentic *Shari'ah* principles and main guidelines of Islamic finance in relation to liquidity risk. Also, an exploration of the key features of Islamic financial contracts and products in relation to liquidity risk constitutes a significant element in the mitigation of the magnitude of liquidity risk. It follows that the main challenge f is to provide supervision of high-quality services that satisfy the spiritual tenets and objectives of the Islamic finance system through the undertaking of specific techniques and policies. (A thorough examination of this key challenge will subsequently help us to develop a better understanding of liquidity risk management within the context of Islamic finance.)

The Nature of Risks Faced by Islamic Banks

As a result of the development and changes in the nature of banking businesses, Islamic banks are exposed to very different kinds of risks. Many factors play significant role in the occurrence of risks, such as increased volatility in the market; rapid development of financial innovations; and increases or changes in competitive and regulatory environments (Iqbal and Mirakhor, 2007). Besides the risks that conventional banks face, Islamic banks have to deal with additional types of risks (See figure 1).

Credit risk is a critical risk that Islamic banks face, as lending is replaced with investments and partnership. Due to the unique characteristics of Islamic finance, Islamic banks encounter unique types of credit risks, such as in the case of *murabaha*, when the bank delivers the asset to the client but does not receive payment from the client on time. *Bay'al-salam*,

Figure 1: Risk Profile of Islamic Banking



Source: Iqbal & Mirakhor (2008) (Modified version).

istisna' contract and *mudarabah* are other areas of finance that encompass credit risks for Islamic banks' operations (Iqbal and Mirakhour, 2007).

Market risk is another important financial risk for Islamic banks, which exposes banks as a result to different types of risks, such as mark-up risk, price risk, leased asset value risk, foreign exchange (FX) risk and securities price risk. For example, in the case of *bay'al- salam*, during the period between the delivery of the commodity and the sale of the commodity at the prevailing market price, Islamic banks are exposed to commodity price volatility (Iqbal and Mirakhor, 2007).

As the interest-based loan is prohibited by *Shariah*, liquidity risk is more serious for Islamic banks as compared with their conventional counterparts (Ahmad and Khan, 2001). For instance, Islamic banks cannot utilize the financial instruments used for liquidity risk management which are accessible on the market to conventional banks such as the inter-bank market, the secondary market for debt instruments, and discount windows from the lender of the last resort; this being the central bank. Such discount windows and debt instruments are interest-based, therefore, they are not *Shariah* compliant.

Another type of financial risk is Asset Liability mismatch risk, which can occur due to different maturities and the conditions of the investment portfolio of the bank on its assets and liabilities levels. In profit-loss sharing investment there is a strong probability of equity investment risk in Islamic banking on the asset side. This constitutes a unique risk to Islamic banks due to equity-based nature of some Islamic financial contracts.

Business risk is another type of particular risk from which Islamic banks are suffering. One of the specific business risks is the rate of return risk, which may occur as a result of the uncertainty of returns of Islamic banks. As part of the business risk, 'displaced commercial risk' is the transfer of the risk associated with deposits to equity holders. This type of risk occurs when Islamic banks suffer from the pressure of paying its depositors a rate of return higher than what should be paid under the actual terms of the investment contract. (Ahmad and Khan, 2001). Withdrawal risk is also considered as one of the business risks that may affect Islamic banks when depositors decide to withdraw their money due to the low rate of return compared with that which their competitors offer or as a result of reputation risk (Ahmad and Khan, 2001).

Governance risk also can also represent a serious risk to Islamic banks. This type of risk arises as a result of failure in governing the bank or negligence in conducting business and meeting contractual obligations in accordance with *Shari'ah*. It may also occur due to a weak internal and/or external institutional environment. Operational risk is a type of governance risk. It is the risk of inadequacy of internal processes such as: risk of failure of technology, systems, analytical models and external risks (Iqbal and Mirakhor, 2007). Another type of governance risk is fiduciary risk, which can be caused by breach of contract on the part of Islamic banks. For instance, the bank may not be able to completely comply with the *Shari'ah* obligations of various contracts (Ahmad and Khan, 2001). Moreover, Islamic banks are exposed to transparency risk due to the lack of standardised of accounting and the reporting of Islamic financial instruments. Governance risk can also be expressed through *Shari'ah* Risk, which is caused, by non-standard practices in respect to different contracts in different jurisdictions and also the failure to comply with *Shari'ah* rules. Finally, reputation risk is another critical risk faced by Islamic banks due to irresponsible behaviour by some Islamic banks. Negative publicity can have a significant impact on a bank's market share, profitability and liquidity (Iqbal and Mirakhour, 2008).

Nevertheless, it has been observed that liquidity risk can play a critical role in bringing financial crisis to the doorstep of Islamic banks. All the categories of risks such as credit risk, operational risk etc., conclude in the structure of a liquidity problem for individual banks and the banking sector as a whole; therefore, it sometimes becomes hard to study these risks in an isolated manner (Ali, 2004), as each one of them is interlinked.

The Key Causes of Liquidity Risk in Islamic Banking

Liquidity risk blights the ability of the bank to match the maturities on the assets and liabilities side and to be able to conduct active portfolio management. Therefore, it is important to know the causes that can make liquidity risk in Islamic banking more severe:

(i) One of the fundamental reasons of the liquidity risk in Islamic banking is limited accessibility of the *Shariah*-compatible money market and intra-bank market.
(ii) The slow development of financial instruments which avert Islamic banks of raising funds from market when needed (Khan and Ahmad, 2001);
(iii) The fact that most available conventional instruments used for liquidity management are interest-based; therefore, they are not *Shariah* compliant;
(iv) Due to certain characteristics of some Islamic instruments, Islamic banks face additional liquidity risks. For instance, the inability to trade *murabaha* or *bay' al salam*, which can be traded only at par value (Iqbal and Mirakhour, 2007);
(v) Islamic banks heavily depend on current accounts which are demand deposits and can be withdrawn at any time (Iqbal and Mirakhour, 2007);
(vi) A small number of Islamic banks, as they emerged recently and very young compared with their conventional counterparts;
(vii) Different interpretations of *Shari'ah* teachings (Islamic financial law) is a critical source of liquidity risk. For example, the contract of *bay' al-dayn* (sale of debt) is allowed commonly and practised in Malaysian financial markets. This type of contract is not permitted by the mainstream of *Shari'ah* scholars outside Malaysia who maintain that debt can be traded only at par value. If trade

is not at par value, it opens doors of *riba* (interest). Therefore, *Shariah* scholars in other jurisdictions need to become engaged in finding solutions for such issues (van Greuning and Iqbal, 2008).

It should be stated that the unique nature of Islamic banks with their purpose of staying away from interest in any form, have additional issues to address in order to cover their liquidity shortfalls in a *Shari'ah*-complaint manner.

Managing Liquidity Risk from the Perspective of Islamic Banking

Real business transactions are the core of practicing efficient liquidity risk management in Islamic banking practices (Antonio, 1999 and Ismal, 2008). This reflects the real economic activities performed throughout the business cooperation and the good behavior of all stakeholders (Iqbal and Mirakhor, 2007). As a result, liquidity risk in Islamic banking stems from the actual circumstances of the economy. As a result of complying with the spirit of Islamic law, the liquidity risk management of Islamic banks is different from that of conventional banks.

As part of liquidity management, liquidity stress in Islamic banks can be managed internally and externally. Internally, considering the trust as the cornerstone of the relationship between all partners, the bank's management, stakeholders and shareholders are considered as trusted business partners. This principle can play a significant role in reducing the liquidity risk of each partner. Externally, liquidity risk is managed through the Islamic financial market system, stimulated via regulators and linked with real economic activities (Ismal, 2008).

Moreover, Islamic banks take a forward role as institutions trusted by their investors and business partners by playing the role of business advisor, consultant and source of knowledge. From the point of view of Islamic banking, if each business partner was left to individually bear the risks involved in his financial activity, business activity would be harshly constrained. It is commercially advantageous to allow business partners to distribute the burden of risk-bearing. The wider the dispersal of risks, the larger the volume of risks that can be tolerated by the business partners. Therefore, the responsibility of liquidity risk is assumed by both the bank and the investors, as they work together and are accountable mutually (Iqbal and Mirakhor, 2007).

Liquidity Risk Management Policy of Islamic Banks

As banks deal with other peoples' money, they should put in place an effective liquidity risk management policy to maintain their solvency. Therefore, it is required to allow an active oversight by the Board of Director (BOD). The BOD, as a key entity in the bank, should set up a liquidity-risk management policy in association with senior management and other bodies and personnel. Taking into consideration the nature of the Islamic banks and their business activities, Islamic banks should review their liquidity management policies periodically which cover (IFSB, 2005):

(i) A policy for managing liquidity risk conducted by well-organized BOD and senior management supervision;
(ii) A structure for developing and practicing sound procedures for assessing and monitoring liquidity;
(iii) The preparation of sufficient techniques for monitoring and reporting liquidity exposures on a periodic basis;
(iv) The provision of adequate funding capability, with exact recommendation as to the willingness and aptitude of shareholders to supply supplementary funds when required;
(v) The provision of liquidity through fixed asset realisations and arrangements such as sale and lease-back; and
(vi) Liquidity crisis management.

In addition, liquidity risk management policy should include both quantitative and qualitative factors. Quantitative factors include the degree of variety and sources of funds, concentration of the funding base, reliance on marketable assets, or availability of reserve lines of exterior funding. Qualitative factors include evaluation of the general capabilities of the management, the bank's reputation in the market, the particular skills in treasury management and public relations, the quality of management information system and the willingness and ability of shareholders to provide additional capital (IFSB, 2005).

Assessment and Monitoring of Liquidity Risk in Islamic Banking

Assessing and controlling liquidity risk can be challenging; because the underlying variables that drive exposures can be dynamic and unpredictable. Indeed, liquidity risk is often deemed to be more difficult to assess than other dimensions of financial risk accurately in view of the fact that it is so changeable. Notwithstanding the challenges, some attempt must be made to estimate the relative level of risk. If this can be done, then the next step in the process, namely controlling risk through limiting mechanisms, can be successfully accomplished. Therefore, to preserve the bank's solvency, Islamic banks should have in place an adequate amount of liquidity. And in order to maintain the required limits of the liquidity that must be reserved, an efficient review and monitoring should be practiced by the Islamic banks periodically (IFSB, 2005: 20). Thus, Islamic Banks, in satisfying the required procedures in respect to assessing the limits of the mandatory liquidity reserve, need to identify any future deficits in liquidity by constructing maturity ladders based on proper time bands. Islamic banks may have their own criteria for classifying cash flows including behavioral methods. Islamic banking categories cash flows in different forms as explained below:

(i) Known cash flows: When the maturities and the amounts are known in advance. This category includes receivables from *murabahah, ijarah, ijarah muntahya bitamlik* (IMB) receivables and diminishing *musharakah*;
(ii) Conditional but expected cash flows: Such as *salam* and *istisna*, conditionality is defined in terms of the type of contract or performance of work based on the agreed terms and conditions over a specific period.
(iii) Conditional and unpredictable cash flows: In some cases, an investment in a *mushārakah* is for an open-ended period and an exit strategy may be assessed periodically. The redemption of invested capital and possible levels of return on investment is conditional upon the performance of conducting business.

Considering Islamic banks obliged to meet their duties, periodical cash flow analyses under various market scenarios and conditions should be practiced. The scenarios may vary depending on local market conditions, and may be based on (a) a 'normal' operating environment; and (b) scenarios of adverse circumstances (IFSB, 2005).

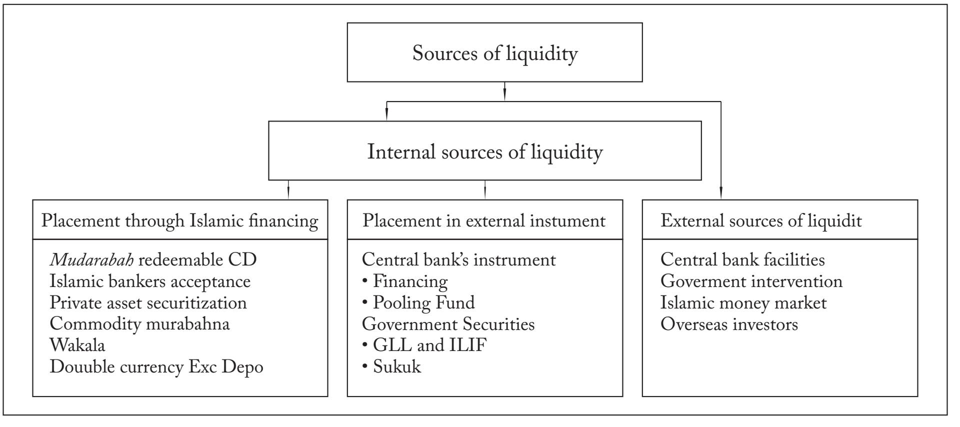
Financial Instruments for Managing Liquidity Risk of Islamic Banks

After explaining policies, techniques and procedures for managing liquidity risk, Islamic banks are required to have access to many types of

Islamic financial instruments to provide liquidity when necessary. Islamic instrument defined by Hassan (1993) and Ahmad (2001: 43) as "a certificate representing common shares in a mobilized fund to be invested for the purpose of sharing in profit. This certificate is negotiable and convertible to money".

Islamic financial instruments, such as central bank instruments and government securities are used by Islamic banks as internal sources. In addition, Islamic banks use central bank facility, government intervention, the Islamic money market and overseas investors as external sources of liquidity. All the instruments are illustrated in figure 2 and detailed bellow.

Figure 2: Sources of Liquidity for Islamic Bank



Sources: Ismal (2008) (Modified version).

Islamic financial instruments

In order to manage their liquidity risks efficiently, many types of Islamic financial instruments are used by Islamic banks, as illustrated in figure 2. Although there is a debate between scholars about the practicing commodity *murabaha* (Cox and Thomas, 2005), it is a vital instrument used by Islamic banks to address the problem of liquidity (Abdul Majid, 2003). It is a structure of a short-term finance based on *murabahah* contract and it is generally used for the selling of commodities on the international market when liquidity is needed (Abdul Majid, 2003). Another instrument used by Islamic banks for short-term placement is *mudarabah*-based redeemable certificate of deposit/ MRCDs (Ahmed, 2001); this constitutes a joint financing agreement between those Islamic banks, which have redemption facilities. Through repurchase (repos) commitment, liquidity is supplied, where the issuer affords liquidity by liquidating the project or the project keeps going while the MRCDs holder sells it onto the Islamic money market (Ismal, 2008). The next alternative instrument of liquidity is the Islamic banker's acceptance (BA), where an Islamic bank acts as agent for a trader dealing in trade and takes fixed commissions (Ahmad, 2001). However, when a liquidity problem occurs, the BA can be sold in secondary market as a quick source of funds (Ismal, 2008). Finally, securitisation is an Islamic financial instrument utilised by Islamic banks to cover liquidity shortfall. It is the sale of ownership rights in high-value tangible assets through the unitisation of the ownership of these assets into monetary- denominated participation certificates to be sold to investors (Maroun, 2002).

External instruments for managing the liquidity risk of Islamic Banks

Beside Islamic financial instruments, Islamic banks use some external instruments for providing liquidity, when needed, such as purchasing government or central bank instruments (Ismal, 2008: 63). According to Kahf (2000), the Islamic Leasing Investment Fund (ILIF) is a useful instrument for covering liquidity needs. It is a government instrument used to purchase assets to lease them. Since these ILIF represents the pro rated ownership of their holders in the tangible assets of fund, they are fully negotiable and can be sold on the secondary market for providing liquidity when necessary. In addition, *sukuk* and Government Investment Issues (GIIs) are instruments used for liquidity purposes. Islamic banks sell GIIs to the central bank, under various modes of underlying Islamic contracts, typically *mudarabah*, *musharakah*, *ijarah*, *salam*, to meet their liquidity needs. GIIs are government securities issued on an Islamic basis (Abdul Majid, 2003).

External sources of liquidity of Islamic Banks

In addition to the Islamic financial instruments and external instruments, Islamic banks have external sources to cover their liquidity needs. One of the crucial external instruments is the Islamic Inter-bank Money Market. Islamic banks can satisfy their short-term liquidity needs by issuing a set of acceptable instruments through the Islamic inter-bank money market (Maroun, 2002). In addition to this, the Islamic international interbank money market and Liquidity Management Center are vital external sources for Islamic banks to gain access to efficient funds to manage their liquidity shortfall (Iqbal and Mirakhor, 2007). Another powerful external source that can be used for liquidity purposes is the central bank's liquidity supply to the Islamic banks under a *Shari'ah* compliancy-code (Abdul Majid, 2003). Finally, as regards Islamic banks, in the case of subordinates, liquidity injections can be provided immediately by parent company (Ismal, 2008).

Conclusion

The emphasis on the liquidity risk has recently become a very prominent issue particularly in the aftermath of the recent global financial crisis. Hence, this paper has attempted to investigate the key feature of Islamic finance in relation to liquidity risk and the techniques used in managing it. It can be comprehended from the preceding discussion that Islamic banks have unique features in relation to liquidity risk management. Therefore, Islamic banks aim to mitigate their liquidity risk by practising and adhering to *Shari'ah* concepts such as cooperation between all the business partners through the sharing of the risks and mutual responsibilities of running the business.

Accordingly, Islamic banks are obliged to have in place effective techniques, procedures and highly industrialized liquidity risk-management practices via appointment of a sufficiently qualified BOD, senior management and other personnel. Efficient accessibility to adequate financial instruments is also significant for Islamic banks to meet their liquidity needs in a timely manner. Based on the achieved empirical results, in order to ease liquidity risk exposure in the Islamic banking sector, innovative approaches are essential in terms of the engineering of new financial instruments and the development of comprehensive regulations and policies.

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Revisiting Takaful Insurance: A Survey on Functions and Dominant Models

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Abstract

Takaful is a growing and fast-developing industry, which offers an insurance policy that complies with Islamic law. Such business is highly recommended by most Muslim scholars because it reflects the real meaning of brotherhood in protecting individual and corporate bodies against loss or hazards to themselves and their properties. As a result, a number of operational models have been applied by takaful operators[1] by adopting one or more contracts, such as Mudarabah, wakalah or waqf. This paper will therefore highlight important issues that deal with the background of Islamic insurance in terms of definition, functions, as well as exploring takaful contract constructions and various mechanisms linking the contract parties. Finally, this paper will highlight the most dominant and practiced models used by takaful operators worldwide.

Keywords: *definitions, Functions, contract mechanisms, models.*

Introduction

Takaful is the Islamic counterpart of conventional insurance. *Takaful* premiums have reported a gradual, yet increasingly high rate of growth. The global *takaful* market was estimated to be at a level of over U.S. $ 2.1bn of premiums for 2002. By 2008 the estimated size of the global *takaful* premium was US $ 5.3bn and to reach US $ 8.9bn in 2010 (Bhatty, 2010). This was expected to rise to a figure of US $ 12.5bn by 2015 (Lewis *et al.*,

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2007). Interestingly, this figure for 2015 was revised from an earlier similar estimate of $7.5 billion made in 1999, which to a great extent indicates that business expectations may have been materializing at a faster pace than initially anticipated, driven largely by strong market growth in the Gulf region and in particular Malaysia (Abdul Wahab *et al.*, 2007). There were some 179 *takaful* companies and windows (20%) in 2008, and the number of such enterprises in 2010 can easily be said to be in excess of 200. The total capital committed within the *takaful* industry in 2007 was around US$ 3.5bn (Bhatty, 2010). Saudi Arabia remains the largest *takaful* market in the GCC with contributions of US$ 2.9 bn in 2008 (E & Y, 2010).

The high growth rate of *Takaful* is strongly based on the unique characteristics of the *takaful* business contract, which differ from commercial insurance business, in that the latter are based on sale and purchase of policy or protection cover in return for a premium payment, and all associated premiums and any investment return profit or underwriting surplus arising from the policyholders collected pools will be automatically directed to the insurance company fund. However, in case of the *takaful* business, the premium payment by the participants[2] is considered as a donation contribution or *"tabarru"*, which is paid for the purpose of brotherhood or mutual indemnity among all participants. The *Takaful*- operated company is considered as an agent to manage the fund contributed to by participants with their full consent. Thus, a clear segregation between the shareholders' and participants' fund(s) is one of the principles on which the *takaful* business is constructed, which satisfies the compliance requirements of the *Sharia'h*[3] compliance requirements. Accordingly, *takaful* business will have different operating models and contractual terms, concept and mechanisms than conventional insurance systems.

Definition of *Takaful*

Takaful is derived from the Arabic root word *"kafala"*, a verb which means guarantee, bail, warrant or an act of securing one's need (Engku *et al.*, 2008).

Takaful is also defined in Section 2 of the Malaysian Takaful Act 1984 as;

"A scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose."

AAOIFI's[4], also defined Islamic insurance on (2004/2005) as per the Financial Accounting Standard No. 12, in Appendix E;

"Islamic insurance is a system through which the participants donate[5] part or all of their contributions which are used to pay claims for damages suffered by some of the participants. The company's role is restricted to managing the insurance operations and investing the insurance contributions."

By 2007 AAOIFI defined Islamic insurance as being in line with *shari'ah* Standard 26 (2) 2007;

"Islamic insurance is an agreement between persons who are exposed to risks to protect themselves against harm arising from risk by paying contributions on the basis of a "commitment to donate". Following from that (principle) the insurance fund is established and is treated as a separate legal entity which has independent financial liability. The fund will cover compensation against harms that befall any of the participants due to the occurrence of the insured risks (perils) in accordance with the terms of the policy."

Functions of *Takaful*

It may be thought at first glance that *takaful* does not deviate from conventional insurance, since both types depend on the concept of pooling money from a group for the sake of helping the unfortunate of the same group in the event of encountering financial loss. However, unlike *takaful*, spiritual mutual support is not a requisite of commercial insurance. Commercial insurance is based on a form of exchange whereby the insured pays a premium in exchange for protection in case of calamity exposure, with "no compensation"[6] in a case of no loss. However, the *takaful* mechanism is based on the concept of *tabarru* (donation)[7] combined with the intention (*niah*) to participate in the pooling aid mechanisms. Hence, those who participate in the *takaful* mechanism will be less likely to encounter the feeling of receiving nothing if no claim occurs. They will feel sufficiently satisfied to help their colleague in the same pooling group in the loss he incurs.

Another unique function of Islamic insurance is the strong relationship between *takaful* operator and participants, in that the *takaful* operator will go even beyond the provisions of "the needs of spiritual satisfaction"[8], by providing nobel services which will be rewarded by God only such as the following benefits for the deceased's family upon the participant's death.

(i) To properly distribute the deceased's estate upon his/her death.
(ii) To calculate and distribute *Zakah o*n behalf of all participants.
(iii) To mandate others to perform Hajj on behalf of the participant upon his/her death.
(iv) To make arrangements for "*Sadaqah Jariah*"[9] (Nordin, 2007).

The conventional method of satisfying a customer is realised by fulfilling their material or worldly needs with benefits such as low prices, higher returns, faster delivery or even benefiting the deceased's family members after his death in the form of life insurance. However, this does not mean that customer satisfaction in terms of price, quality, delivery and precision are not important to the *takaful* operator; in fact they remain important while the satisfaction of the customer's spiritual needs are also met. So when Muslims buy Islamic insurance they can combine two benefits; (i) They receive Islamic protection that complies with *Shari'ah* rules against financial loss, in the same way as conventional insurance guaranrtees, as well as (ii) distancing themselves from the possibility of sin[10] incurred by purchasing conventional insurance.

Finally, although a believing Muslim is required to accept destiny, which may incorporate certain misfortunes, Islam encourages Muslims to take extra precaution to minimize potential misfortune, losses or injury arising from unfortunate events. Thus, having an insurance policy is not considered to be against the will of Allah, rather the will of Allah can be enhanced by holding an insurance policy to offset (?) the unexpected risk that exists in day to day life. (Al-Zarqa, 1962; Attar, 1983).

Takaful Contract

The majority viewpoint held by contemporary Islamic scholars is that *takaful* contract is fully consistent with *Shari'ah* principles (Fisher *et al.*, 2000; Al-Salih, 2004). Akin to English law dealing with contracts, Islamic Law has established fundamentals which are required in an insurance policy, such as "parties to the contract, legal capacities of the parties, offer and acceptance, consideration, subject matter, insurable interest and utmost good faith" (Dacey, 1989). The presence of certain elements and the absence of others can make a difference between a valid or void contract in the eyes of *the Shari'ah*.

As for the mechanisms of the *takaful* contract, There are four parties involved in a *takaful* contract, namely: the participant[11], operator[12], insured person, and beneficiary[13]. Hence, cooperation among these parties creates four mechanisms in the *takaful* scheme.

(i) Contract between participant and fund
The money belonging to the participant is transferred to the fund. In current practice, the fund is based on the principle of *tabarru*. In case of loss risk, the participant ,as is also the case with the members of the fund, can receive benefit by the cover that the fund provides. Thus, the money belonging to the fund is transferred[14] to the participant. The current *takaful* practices are based on "commitment to *tabarru*"[15], *i.e.* the *takaful* operator as the agent of all participants can claim a premium from participants, because the ownership has been transferred when the agreement was signed. However, if the contract is based on (pure *tabarru)* then the *takaful* operator cannot make demands to the participant to pay the premium, because the ownership was absolutely transferred when the participant delivered his premium and delivery did not occur when the agreement was signed.[16]

(ii) Contract between company and participant
The relationship here is not as insurer-insured rather than of a participants-operator one; the participants insure themselves, while the *takaful* operator is engaged by the participants to manage the *takaful* scheme on behalf of them (Engku *et al.*, 2008). The participant in a *takaful* contract is considered to be a *muwakkil* (principal) and the company as a *wakil* (agent) to manage the participant's money. The

duties of the company as a *wakil* or agent of the participant, is to manage the fund in terms of a contractual arrangement, and to undertake all administrative matters, underwriting activities and technical issues, as well as to manage the investment portfolio of the fund. Depending on the type of the underlying contract, the *takaful* operator may receive a fee, or share the profit on investments as a reward for managing the *takaful* scheme. The *takaful* company and the participant will enter into a long-term *takaful* contract, whereby the contract spells out clearly the rights and obligations of the parties to the contract. The participants are then required to pay the *takaful* instalments on a regular basis. In return for participation in the *takaful* plan, the customer decides the amount of *takaful* instalments that he/she wishes to pay subject to the company minimum sum at the time of signing the contract. (Hassan *et al.*, 2007)

(iii) Contract between company and fund:
The relationship here is to be regarded as a contract to invest the participant's money; the money belonging to the fund is transferred to the company, acting as a *wakil*[17] or as *mudharib*[18]. The *mudharib* will invest the general *takaful* fund in line with *Shari'a*h principles and all returns on the investment will be pooled back into the fund. On the other hand, the participants agree that the company shall pay from the general *takaful* fund, compensation or indemnity to fellow participants who have suffered a defined loss. The fund shall also pay for other operational costs of general *takaful* business such as re-*takaful* arrangements and the setting up of technical reserves (Tolefat, 2008).

(iv) Contract of the participant's mutual assistant:
Under this system, participants mutually and voluntarily agree to contribute money to support a common goal of providing mutual financial aid to members of the group in case of specific need[19], this system is based on "mutual protection and solidarity"[20]; the participants should embody certain "principles and beliefs"[21] when dealing with each other (Ali, 2006).

On the other hand, everyone is allowed to buy a *takaful* policy whether Muslim or not. In fact, in Malaysia, non-Muslims make up the largest portion of *takaful* policy- purchasers by 2007 with a share of 60% (Bhatty, 2008). However not everyone is allowed to sell *takaful* policy.

Types & Models Of *Takaful* Contract

The *takaful* products are available in two forms: *general*[22] and *family*[23]; the product shelf of the general *takaful agreement* is more comprehensive than that of the family *takaful* . The global average market-share figures for *mix-life* and general *takaful* were 30% life to 70% non-life by 2007. However there are some reasons that lead family *takaful* to lag behind general *takaful* (Bhatty, 2008).

(i) Religious concerns;
(ii) Life insurance appeared to be more as a wager on life, since it has intangible benefits.
(iii) Islamic investment tools were short term in nature and very limited.
(iv) The need for well-educated and talented people to handle general *takaful* products.

Sudan was the first nation to introduce family *takaful* followed by Europe and Malaysia in early 1980, and Qatar and Bahrain in 2001 and 2002 respectively. The Arab countries are more focused on the group family *takaful*. Malaysia, Singapore, and Indonesia are offering several plans[24] for family *takaful*. In contrast, General[25] *takaful* started first in Sudan in 1979 and had then were created for the Middle East markets by early 1980s including: the UAE in 1980, Saudi Arabia in 1983, Bahrain in 1989 and Qatar in 1995, driven by the boost in economic development as a result of high oil prices.

On the other hand, there are several *takaful* operational models that have been adopted by *takaful* operator companies world-wide such as *mudarabah*, *wakalah*, *waqf*, hybrids of *mudarabah* and *wakalah*, *ta'awuni* and non-profit funds. However the first two models are most dominant, due to the fact that the *mudarabah* is widely used in Asia, while *wakalah* has become popular in the Middle East (Smith, 2007).

Basic *Wakalah* Model

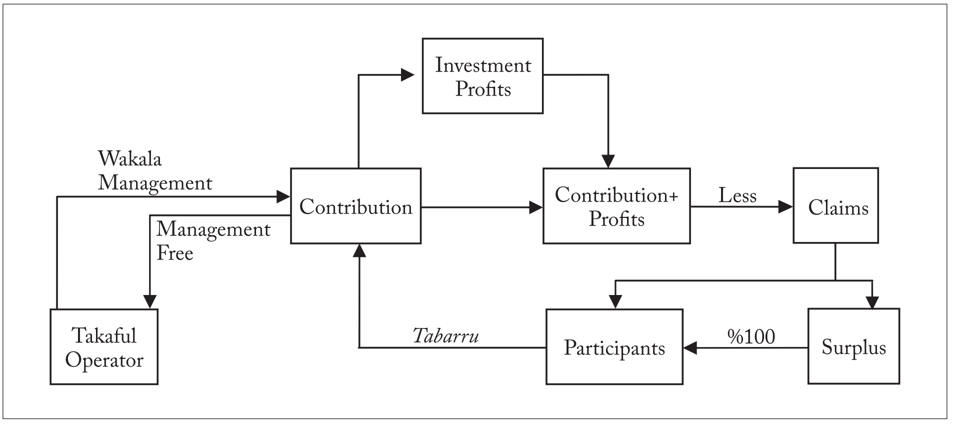
General takaful

There will be separate contracts in the *wakalah* model, of which one is used for underwriting and the other is used for the investment activities of *takaful* funds. Although the *wakalah* model has been widely practised by *takaful* operator companies in underwriting activities, it is rarely adopted for investment activities (Tolefat, 2008). In the *wakalah* model the participants place their contribution into a pool of donation (*tabarru*), hence the *wakalah* operator, is entitled to a fee (*wakalah* fee), for their effort to manage the *takaful* fund regardless of the performance of the pool. It is an (upfront fee)[26] which is calculated based on an agreed percentage of the total fund. The *wakalah* fee should be approved by the *sharia'h* supervisory board (SSB)[27]. Thereby, most of the operators will declare their *wakalah* fee at the beginning of the contract, but the 'loading' will be calculated at the end of the year once the actual encountered expenses have been declared according to an accurate fee calculation. The *wakalah* fee should be directed to the shareholders' fund as an income for the operator. After that action is conducted, the operator manages the fund by complying with the following procedural steps.

(i) All "direct expenses"[28] are deducted from the remaining fund.
(ii) "Indirect expenses"[29] are paid by the operator only if there is a surplus in the *takaful* fund that has been shared between the operator and the participants, otherwise it will be paid from the *takaful* fund (Lewis, 2003).
(iii) Participants will give the right to the ope tor to invest their funds for an operator investment fee[30].
(iv) The *takaful* fund at this stage represents the income generated from investments after deduction of the management fee for the operator with the underwriting surplus added. The combination of both of these amounts represents the total surplus in the *takaful* fund.
(v) The operator takes part of the surplus as a reserve to strengthen the position of the *takaful* fund.
(vi) The remaining surplus in the *takaful* fund is solely owned by the participants[31] and the operator has no right over this fund as per AAOIFI[32].

As a result, the *takaful* operator has three sources of income (i) the *wakalah* fee from underwriting activities, (ii) the fund investment fee and (iii) investments on the operator's own capital.

Figure 1: Basic *Wakalah* Model for General Operational

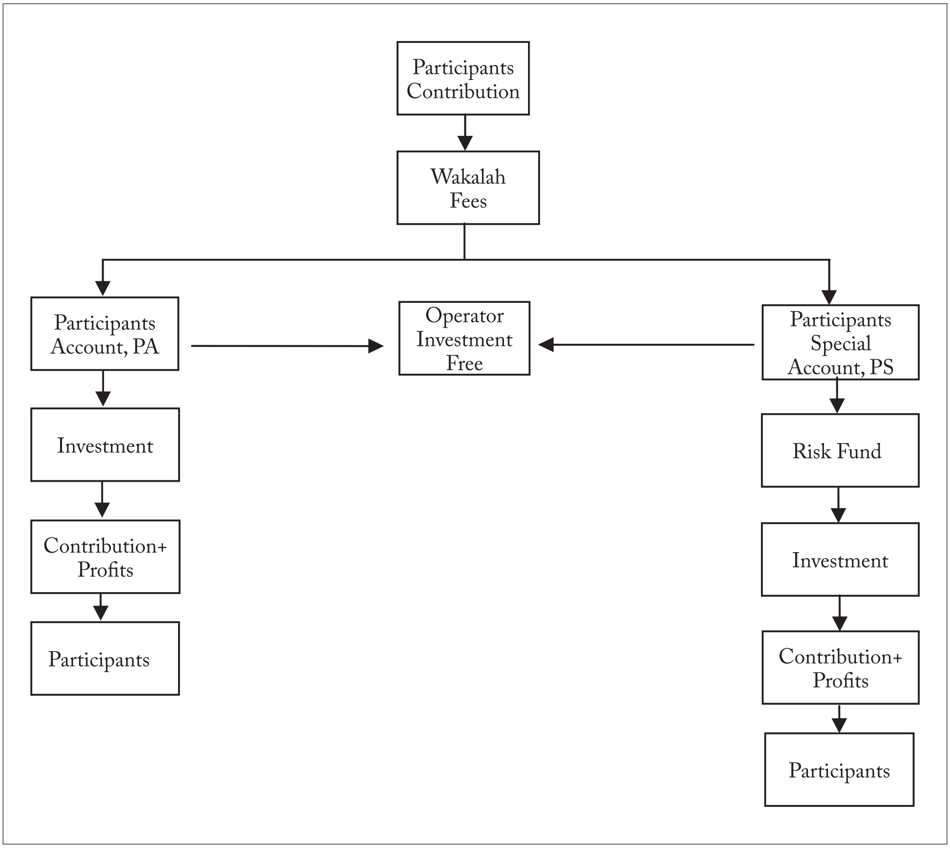


Source: Engku et al. (2008, 53); IFSB (2009, 28)

Family takaful

Like the general *wakalah* model, the model here used for underwriting and investment activities, the model here can be deviated according to the nature and sensitivity of the underwriting policy encountered (Tolefat, 2008). For example, if the policy concerns (i) risk protection from death, then the contribution splits into two channels. The first contribution goes to the *wakalah* "Agent", for their management effort and other fees related to the family policy "if any", while the second contribution goes to the Participants' Special Account "PSA", in the form of donations[33] (*tabarru*) to participate in the risk of death protection pooling. On the other hand, if the policy is written as (ii) a Family *Takaful* savings policy, then the contributions are split into three channels. The first two channels follow the aforementioned policy. However, a small portion this time goes to the PSA to cover mortality risk, while a substantial portion goes to the Participants' Account "PA" for the purpose of savings and investments. Furthermore, the PSA, and shareholders fund operate in the same way as the *takaful* operates in general. While the PA represents the savings policies, most of the investments here are accomplished on a long term basis, thereby the *takaful* operator deserves a management fee which is calculated as a percentage of the total invested assets, and this fee represents their effort to manage such an investment fund. The *takaful* operator as a result has four sources of income; (i) *the wakalah* fee from underwriting activities, (ii) a fund investment fee from the PSA, (iii) a fund investment fee from the PA and (iv) an incentive performance fee if allowed per the operation procedures.

Figure 2: Basic *Wakalah* Model for Family Operational



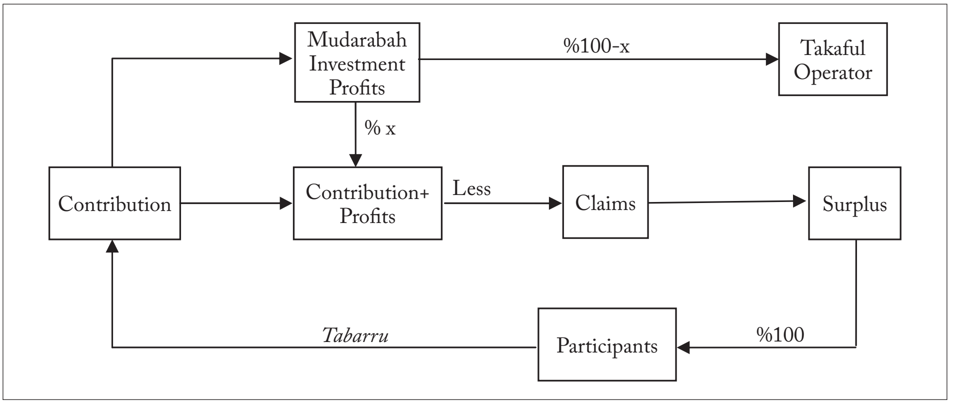
Source: IFSB (2009: 28)

Basic *Mudarabah* Model

General takaful

The contract under the *mudarabah* model will involve profit sharing between the investor[34] (*rabb al-mal*) and the fund manager (*mudarib*), according to a predetermined ratio. In the classical contract there is no fixed return for investors as profit is undetermined and the operator or the *mudarib* has full control, *i.e. rabb al-mal* cannot participate in the ordinary course of business conducted by the *mudarib*. However the *mudarabah* investments are considered a side activity to optimize the use of funds until claims are made or other expenses are incurred (Engku *et al.*, 2008). There is only one contract to cover both underwriting and investment activities, the contract scheme usually operates on the basis of one-year participation. There will also be no upfront management fee or investment fee to be taken out of the contribution toward the shareholder's fund as in the *wakalah* model, however other expenses such as claims, re-*takaful* arrangement and direct expenses are deducted directly from the *takaful* fund that was paid by the participants, while other indirect expenses such as salaries and rent will be paid from the shareholder's fund (Hassan *et al.*, 2007). Furthermore, the operator and the participant's only share direct investment income in accordance with a mutually agreed *mudarabah* profit share, while the underwriting surplus after deduction of all claims and reserves should not in principle be shared with the operator because they are not a *mudarabah* investment profit, but instead a residue of the *takaful* fund (Engku *et al.*, 2008). The *Takaful* operator as a result has two sources of income: (i) profit share in the investment activity surplus and (ii) profit on their capital investment activities.

Figure 3: Basic *Mudarabah* Model for General Operational

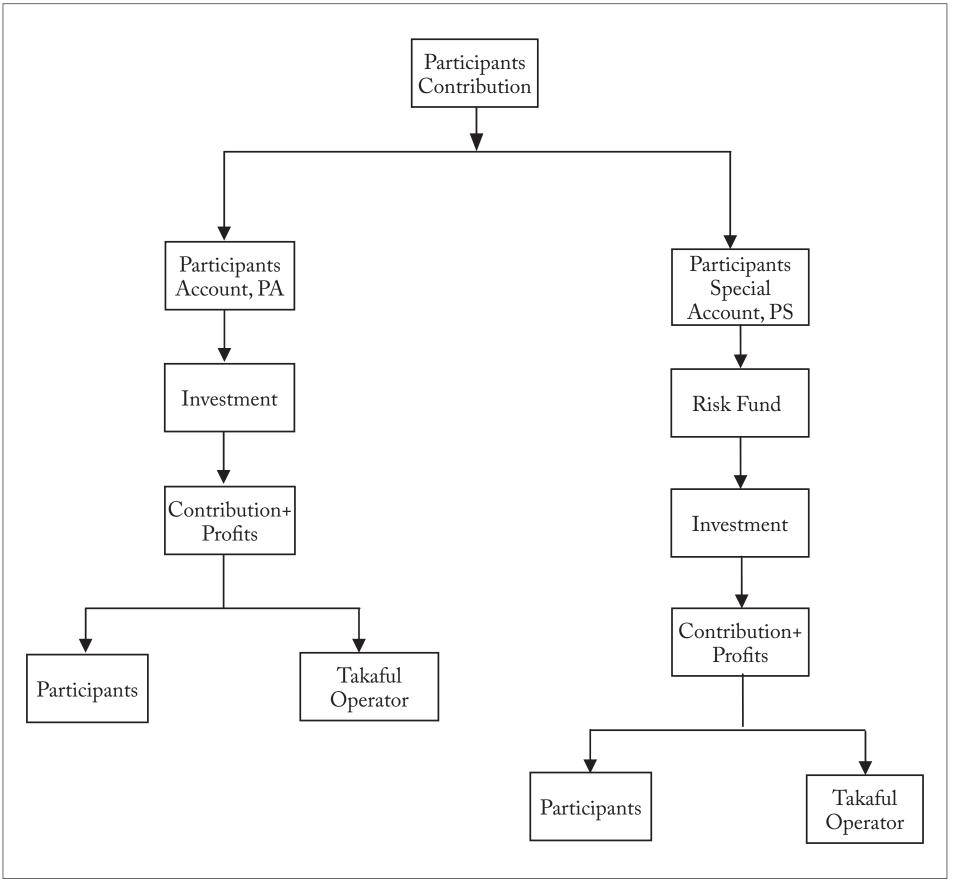


Source: IFSB (2009: 28)

Family takaful

The operator scheme here follows the same operation channels as those of the shareholder's fund and the PSA that were adhered to in the *wakalah* family model. However, since the PA contains only a saving element of family *takaful*, then the operator share profits are generated from the investment activities of the PA. The *Takaful* operator as a result has two sources of income; (i) the profit share from investment activities for PSA and (ii) the profit share from the asset investment under PA.

Figure 4: Basic *Mudarabah* Model for Family Operational



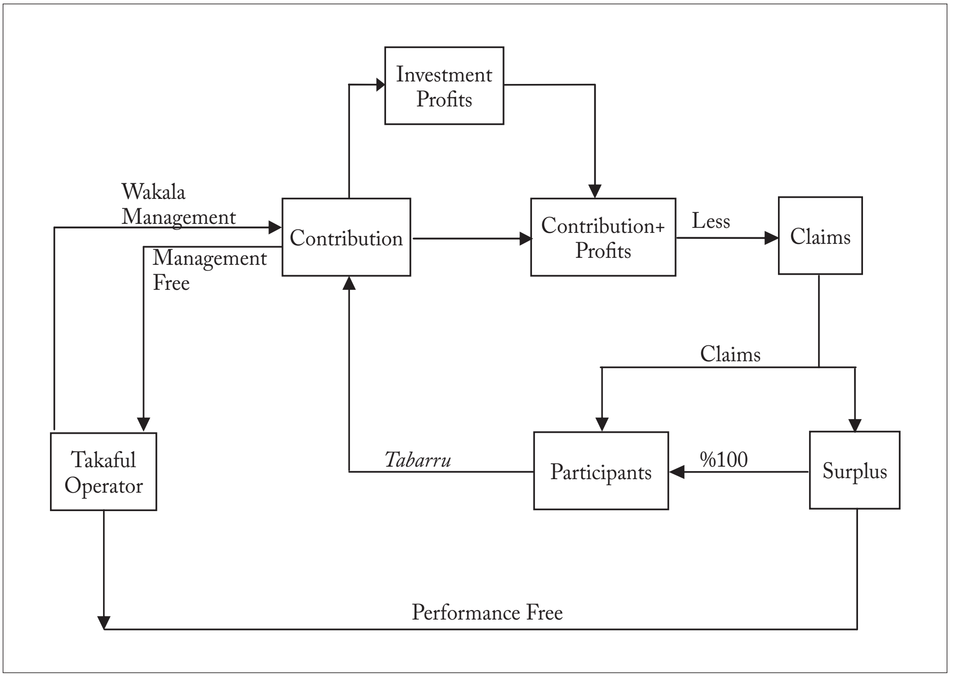
Source: IFSB (2009: 28)

Modified *Wakalah & Mudarabah* Model

Modified wakalah model

The modified *wakalah* model follows the same operational concept as in the (basic) general *wakalah* model. However, as the operator here will share in the "net underwriting surplus"[35] of the participants' fund, such an act should be conducted only with the full consent of the participants (Engku *et al.*, 2008; Asaria, 2009). The *Takaful* operator as a result has four sources of income: (i) a *wakalah* fee from underwriting activities, (ii) a fund investment fee, (iii) investments on the operator's own capital and (iv) an incentive performance fee, *i.e.* sharing in the net underwriting surplus of the *takaful* fund.

Figure 5: Modified *Wakalah* Model Operational



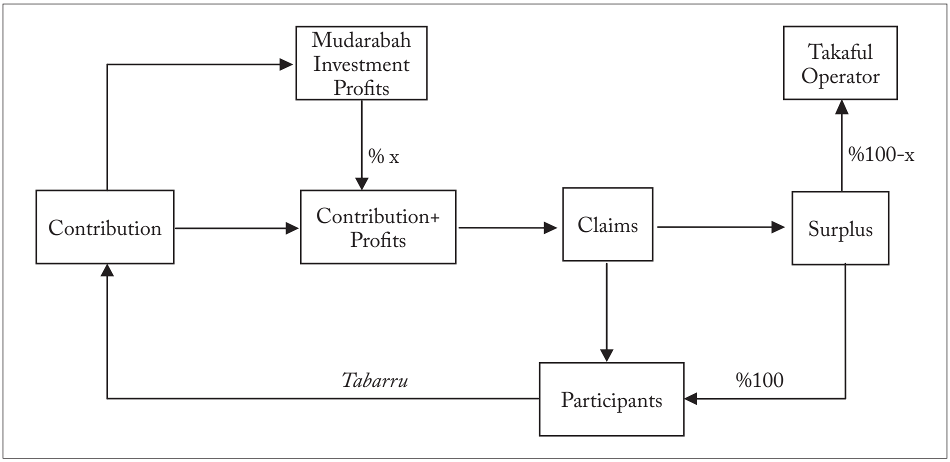
Source: Asaria (2009:11)

Modified Mudarabah model

The modified *mudarabah* model follows the same operational concept of the basic *mudarabah* model. However the operator will share in the "net underwriting surplus", while the investment income is ploughed back into the *takaful* fund, *i.e.* the operator will not share with the participants in any profit arising from the *mudarabah* investment (Engku *et al.*, 2008; Asaria, 2009).

The profits are defined as the 'positive difference' (or surplus) between the balance of the *takaful* fund at the end of the *mudarabah* contract and the balance of the *takaful* fund at the beginning of the *mudarabah* contract, *i.e.* the operator treats the 'net underwriting surplus' as *mudarabah* profit and shares the 'surplus' according to an agreed profit sharing ratio[36]. The *Takaful* operator as a result has two sources of income under this model: (i) profit share in net underwriting surpluses, and (ii) profit on their capital investments activities.

Figure 6: Modified *Mudarabah* Model Operational



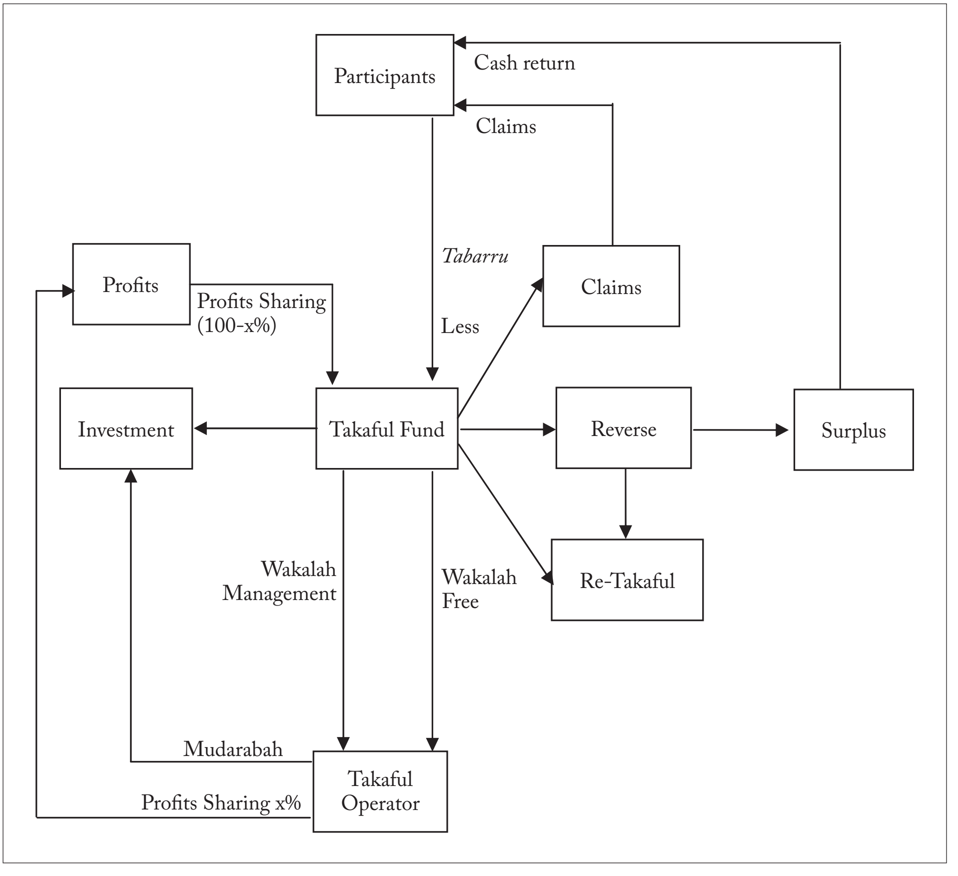
Source: Asaria (2009:10)

Mixed Module

General Takaful (Wakalah for Underwriting & Mudarabah for Investments)

Under this model[37] the *wakalah* contract is used for underwriting activities, risk assessments, re-*takaful* and in return for claim management, the *wakil* charges a specified and agreed management fee. This fee may vary based on the performance of the *takaful* operator (Engku *et al.*, 2008; Asaria, 2009). At the same time, a *mudarabah* contract is used for the purpose of investments in which the operator acts as a *mudarib* on behalf of the participants; that is the operator manages the *takaful* fund assets and share in the income generated from the investments based on a pre-agreed profit ratio at the contract inception period to satisfy the *Shar'iah* requirements. Unlike, the *wakalah* model, the operator receives a share in the profit once generated from investment, otherwise there would be no income generated for the operation; however, the participants remain liable for a loss encounter. The *Takaful* operator under this model has four main sources of income; (i) profit from the *wakalah* fee for underwriting activities, (ii) the profit share generated from asset management of the *takaful* fund, (iii) profit from the operator's own capital investments, and (iv) a possible sharing on the investment return, as an incentive fee for good performance.

Figure 7: General *Wakalah-Mudarabah* Model Operational

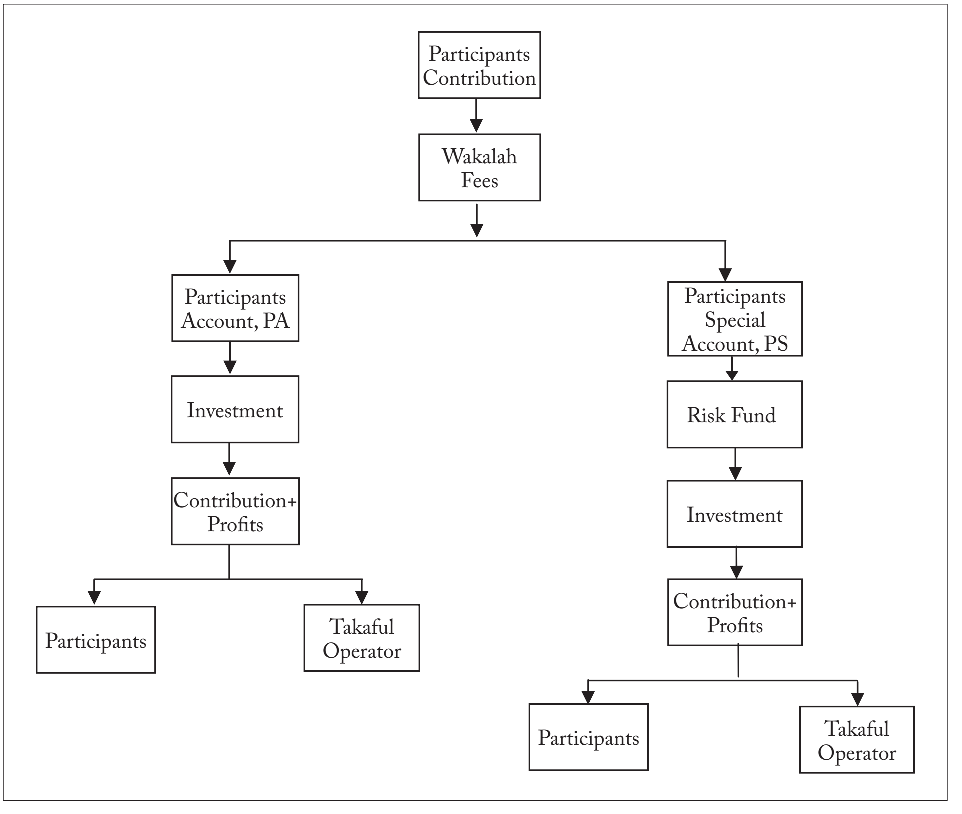


Source: Engku et al. (2008: 53)

Family Takaful (Wakalah for Underwriting & Mudarabah for Investments)

Under this scheme the shareholders' fund and the PSA operate the same way as in the general mixed model, while the operator invests in the PA fund on a *mudarabah* basis, the generated profit will be shared between the operator and the participants upon the agreed ratio. The operator has five main sources of income in this model: (i) profit from *the wakalah* fee for underwriting activities, (ii) a profit share under PSA investment activities, (iii) a profit share under PA investment activities and (iv) profit from the investment of the operator's own capital coupled with (v) the possibility of incentive payments or 'good' performance fees.

Figure 8: Family *Wakalah-Mudarabah* Model Operational



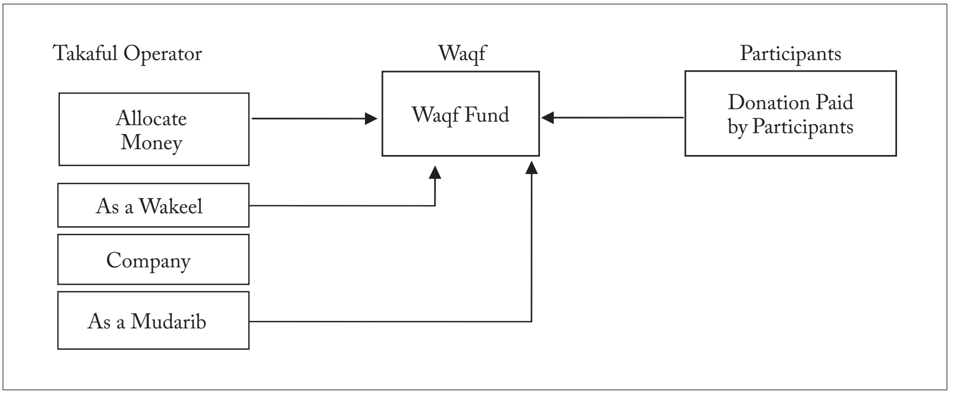
Source: IFSB (2009:30)

Waqf Takaful Model

A Waqf[38] is established by the equity holders of the *takaful* company to compensate the beneficiaries or participants of the *takaful* scheme in the utmost sincerity in order to help those faced with difficulties (Ismail, 2006). The participants of the *Takaful* will give a premium under the intention of a donation or *'Tabarru'* to the *waqf* to participate in the objectives of the *takaful* principles; the donation of the *waqf* can be determined by the *takaful* company on the basis of an actuarial estimate. Any person signing the proposal form, contributing to the *waqf* and subscribing to the policy documents shall become a member and a beneficiary of that *waqf* fund (Ismail, 2006). However, shareholders do not have the right to access the *waqf* fund's capital, assets or profits but rather their job is to make rules for and administer the fund (Tolefat, 2008).

Claims on surplus after deduction and other expenses will be distributed according to the *waqf* deeds into three options: (a) a portion will be used as a reserve to mitigate any future losses, (b) a portion is to be distributed back to the participants, and a portion is to be distributed to the poor and for charitable purposes (Engku *et al.*, 2008). In case of a deficit in the fund the operator will provide *qard hassan* to cover the deficit. The *qard hassan* will be repaid from future surplus in the fund (Tolefat, 2008). *Waqf* is considered a legal entity that can exercise ownership rights over the contribution amount subject to the terms of the *waqf* deed, particularly on investments, compensations and the status of surplus amount (Engku *et al.*, 2008). Finally, if the fund is liquidated, then the outstanding balance, after the payment of all dues and payables, will be utilized for charitable purposes (Ismail, 2006).

Figure 9: The relationship between participants and the *takaful* operator in the *Waqf* scheme.



Source: Cizakca (1998)

Takaful-Waqf operation models

The *takaful* operator is the manager of the *takaful waqf* fund; hence they will administer the fund based on two forms;

(i) *Wakala - waqf*

As Operator/Manager, the *takaful* company will perform all functions necessary to manage the insurance activities of the *waqf*, such as the underwriting of contributions , the actuarial assessment of risks and payment of claims. The management will be conducted under a *wakala* fee to be deducted from the contributions of the participants.

(ii) *Mudarabah - waqf*
As *mudarib* of the fund, the *takaful* company will manage the investment of the excess funds of the *waqf* into *Shari'ah*-compliant investments and will participate in the profit of the fund's investments at a fixed, pre-agreed profit ratio.

Other *Takaful* Models

The Sudanese model

The system of *takaful* operating in Sudan worked the same way as the mixed *wakalah - mudarabah* model that *wakalah* used for underwriting activities and *mudarabah* used for investment activities. The operator acts as a manager looking after participants' funds and dealing with technical issues for a *wakalah* fee, however the fee is not calculated as a percentage of the total available fund rather as a lump sum to be used as remuneration to the board of shareholders. The remuneration amount is considered negligible compared with the regular *wakalah* percentage fee. A *wakalah* percentage fee of the total contributed amount was prohibited by the Higher *Sharia'h* Supervisory Council (HSSC) in Sudan; they considered the *wakalah* percentage fee as *riba* in the sense that the money is accumulated without any effort on the part of the company (Al-Darir, 2004). Al-Dariar argues that the participants of an Islamic insurance company should establish the company and should act as shareholders of the company in the same way as in the mutual insurance company. He also believes there is no need for capital in the Islamic insurance company except to satisfy the legal requirements to establish the company. The shareholders are not allowed to share the surplus of the *takaful* fund or to share in the investments' profits, and are also not required to provide *qard-hassan* in the case of deficit. The loan amount can be taken from the available fund reserves; if the reserves are not sufficient to compensate the deficit, then the operator will establish a central fund to act as the lender (Al-Darir, 2004).

The Saudi Arabian cooperative insurance model

The Saudi Arabian Monetary Agency (SAMA) requires all insurance companies to operate under a cooperative insurance business model, which is a key feature of the *takaful* model (E & Y, 2010). *Shari'ah* scholars have indicated that the Saudi cooperative model is similar to a *takaful* model (in that it incorporates funds segregation and surplus distribution).

The cooperative insurance model works in the same way as the *takaful* model. The SAMA directives , officially set out in the Implemented Regulations, Article 70, has identified the surplus distribution as being between the company and the participants. SAMA has indicated that 10% of the net surplus shall be distributed to the policyholders either directly or in the form of reduction in premiums for the next year. The remaining 90% of the net surplus shall be transferred to the shareholders' income statement. Shareholders' net income shall be transferred to the statement of shareholders' equity similar to how this is conducted in the *takaful* model. Furthermore, 20% of the net shareholders' income shall be set aside as a statutory reserve until this reserve amounts to 100% of the paid capital (SAMA, 2005). Therefore, any deficit in the policyholders' fund is borne solely by the shareholders. Despite SAMA regulations, which are directed towards cooperative insurance, only a number of cooperatives operate as sole TO (E & Y, 2010, 2011). Examples of these operators are (AlJazira, 2008; SAAB, 2009; AlAhli, 2010).

Conclusion

The main issue that distinguishes *takaful* from conventional insurance is the concept of *taburru* and the unique and fair treatment of participants which is quite obvious by separating the shareholders' fund from the participant's fund, in that each party will have his own balance sheet. Furthermore, some operators might use a homogeneous model such as *wakalah* or *mudarabah*, while the other might use a hybrid of *wakalah* and *mudaraba; namely,* they use the *wakalah* model for underwriting and the *mudarabah* one for investment. Such a mixed approach has been adopted by several operators worldwide[39]. Accordingly, *takaful* contractual concepts, terms and mechanisms will differ from conventional insurance in that in the *takaful* business there will be a strong relationship between participants and operators, participants and participants, participants and fund, operator and fund. Finally, *takaful* is still at the development stage with a number of challenges yet to overcome, such as innovative products, building *re-takaful* capacity, asset management and marketing channels, and the standardisation of *takaful* models worldwide.

Endnotes

1 The word operator used in the takaful business instead of insurer, which shows a strong relationship between takaful company and its participants, that the operator considered as a custodian of the participants fund and not the owner of the fund, which comes in contrast of the conventional insurance that the conventional insurer is considered the owner of the fund.
2 Policyholders.
3 The Islamic law.
4 "Accounting Auditing Organization for Islamic Financial Institutions"
5 The concept of donation is considered to be the backbone of takaful in supporting the real meaning of mutual cooperation, as per [Quran, 5:].
6 The insurance value will be so intangible that its value cannot be appreciated
7 Al-Qaradawi suggests that donation should be the basis of the contract, if insurance is to be shari'a -compliant (Al-Qaradawi,2003). The spirit embodied in the concept of tabarru is that the participants are not thinking only of their own protection but they should also be thinking of helping other participants, without the concept of donation the contract will be that of buying and selling of insurance. (Lewis, 2003)
8 implementing the Islamic law when dealing with insurance
9 Continued charity such as building mosques, libraries, hospitals and schools on behalf of the participant upon his/her death
10 Based on three prohibition elements: (1) uncertainty of outcome (gharar), (2) gambling (maisir), and (3) dealing with Interest (riba) which is frowned upon by Shari'ah law.
11 Those among the participants who face the risk and are assisted by the fund are known as insured (almoaman alih).
12 The operator is defined according to Section 2 of the takaful Act 1984 as "a person who carries on Takaful business as Takaful operator, Takaful agent and Takaful broker respectively".
13 Those who contributed to the mutual fund (ra's al-mal) are known as participants (sahib al-mal), while those who actually benefit from the fund are known as the beneficiaries (al-mostafid) of the cooperative fund.
14 When the risk events occur.
15 The difference between pure tabarru and commitment to tabarru depends on the timing of the transfer of the ownership. In pure tabarru the ownership of the "mutabarri" (donator) is not transferred by the absolute contract wording, but rather transfer occurs while handling the donation to the needy, i.e. ownership of such materials "money" has been transferred from the donator to the needy once it reaches the needy custody. In the commitment to tabarru, the ownership is automatically transferred to the mutabarra (donated person) by the absolute contract
16 Based on an Interview with Dr. Abdul Sattar Abu Ghuddah, Member of the Islamic Fiqh Academy, Jeddah, at the First Public Meeting with Bank AlJazira Sharia Board Members, Hilton Hotel Jeddah, Oct. 2009.
17 if the contract is based on wakalah
18 if the contract is based on mudharabah
19 Such as perils or hazard.
20 If the participants are intending to invest some of the money as their savings and donate some portions for mutual indemnity, then the governing contract is musharakah, together with tabarru or donation of a portion of the contribution to the takaful fund (Ali and Odierno, 2008).

21 Such as “piety purification, brotherhood, charity (tabarru or contribution), mutual guarantee, community well-being as opposed to profit maximization.
22 Islamic General Insurance.
23 Islamic Life Insurance.
24 Within the scope of Family takaful are offered different types of saving and protection products, such as education, mortgage, retirement plans, protection for critical illness or disability, retirement annuities and waqf plans. A family plan may last as long as 10, 15, 20 years or more (Bhatty, 2008).
25 General takaful is more concerned with causality types of product in the form of individual retail products such as household fire protection, motor, medical and health cover, personal accident protection during Hajj season, or corporate segment products such as marine and aviation to cover transit cargo, engineering, or fire, the contract for which normally stands for one year.
26 The operator cannot ask for an additional wakalah fee in the future if the calculated fee was underestimated.
27 CCB Rulebook, 2005.
28 Such as claims, expenses, legal claims costs and re-takaful arrangements.
29 Such as salaries and rents.
30 Based on an agreed percentage of the total managed assets regardless of the investment performance.
31 It is wise to mention that some companies distribute the surplus for all participants including those who incurred a claim to satisfy the main purpose of insurance in Islam.
32 AAOIFI shari’ah standard No. 26 (5/5) of 2007 rules stated “Surplus can only be distributed back to the participants and cannot be taken by the takaful operator; the distribution of surplus will be based on the participant’s donation percentage share”.
33 Participant’s donation varies in accordance to his age at the time of the contract (Hassan and Lewis, 2007).
34 The participants do not pay their contribution for the mudarabah investment capital as a principal objective. The main objective remains to enter into a brotherhood mutual indemnity scheme by implementing the donation or tabarru contract.
35 The underlying argument is that since the operator will provide qard hassan to cover any deficit in the takaful funds, then the operator is entitled to share in the positive performance of takaful funds. Additionally they argue that the surplus is a result of ‘good’ and expert management by the takaful operator especially in the underwriting of contributions, assessment of risks and claim management. On account of the fact that good management has contributed to the availability of the surplus , they should be consequently rewarded for such good performance.
36 Such a practice been criticized as not complying with the definition of profit in mudarabah and thus is not compliant with mudarabah rules generally (Engku et al., 2008; Asaria, 2009).
37 This model is highly recommended by the AAOIFI to be used by the takaful operator (AAOIFI, 2003). It has a dominating presence on both Middle Eastern and global markets.
38 The word waqf and its plural form awqaf are derived from the Arabic root verb waqafa, which means causing a thing to stop and stand still. The second meaning is simply pious (charitable) foundations (Cizakca, 1998). In Shari’ah, waqf is a voluntary, permanent, irrevocable dedication of a portion of one’s wealth in cash or any other kind to Allah (Ismail, 2006).
39 Takaful international in Bahrain, National Takaful in Malaysia, Islamic Insurance company in Qatar.

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Islamic Microfinance as an Alternative for Poverty Alleviation: A Survey

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Abstract

The purpose of this paper is to demonstrate the potential of Islamic Microfinance as an alternative tool for poverty alleviation. While poverty is a common problem faced by all countries, the efforts and actions has not reached the purpose yet. Still, it calls more attention from majority of government and development oriented organization to alleviate it in an effective and comprehensive approach. In Islamic perspective, poverty is not just viewed from material aspect but also moral/spiritual, thus, any poverty alleviation strategy should reflect on both aspects. It might be argued that while conventional approach on poverty left the importance of committing to moral/spiritual, Islamic approach has more attention on that aspect. Islamic microfinance, having a unique feature compare to the conventional counterpart, offers a potential solution to poverty alleviation. The underlying principle of Islamic microfinance is the application of Islamic values to promote social justice for all and to achieve economic development with building human capability as center of attention. Hence, the content of moral and value aspect, emphasizes on the human side and communities responsibility, is likely to be more effective and comprehensive in poverty alleviation.

Keywords: *Islamic, microfinance, shari'ah, poverty alleviation.*

Introduction

Poverty is obvious, it occurs everywhere in the world, and seems to be "… the biggest moral challenge of this century" (Obaidullah, 2008b: 30). It called attention from majority of government and development-

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oriented organisation to alleviate it in an effective and comprehensive approach. In Islamic perspective, poverty is not just viewed from material aspect but also from moral/spiritual, thus, any poverty alleviation strategy should reflect on both aspects. It might be argued that while conventional approach on poverty left the importance of committing to moral/spiritual, Islamic approach has more attention on that aspect. Islam support capacity development building through microenterprises as a way to empower the poor and graduate from poverty. However, they face problems; among others, financial problems seems to be biggest one, therefore the year of 2010 has been renowned as the year of Islamic microfinance, sharing the spirit of helping microenterprises through micro financing.

Given the main problem of the poor is lack of financial access; this paper argues Islamic microfinance offers an alternative solution to poverty alleviation through more human oriented financing. This is due to the underlying principle of Islamic microfinance is the application of Islamic values to promote social justice for all and to achieve economic development with building human capability as centre of attention. Hence, the content of moral and value aspect, emphasizes on the human side and communities responsibility, is likely to be more effective and comprehensive in poverty alleviation. Also, researchers criticised interest based modes in conventional microfinance and finds the problems of "… non graduation from poverty, debt trap, high drop out rate, asymmetric information and economic viability of the project" (Ahmed, 2002: 58). In contrast, some studies find positive impacts of Islamic microfinance both in economic and social aspect. Although there are some weaknesses and problems found in certain location in terms of insufficient regulation and limited assets (Seibel, 2005), however, Islamic microfinance still attractive to be considered.

This paper will explore this area to provide broader overview on this issue, it will be organised as follows: section 2 will discuss about poverty is Islamic perspective, continued by presenting the Islamic microfinance and its nature, model, and strategies in section 3, then leading to performance and economic impact of Islamic microfinance in the next section.

Poverty in Islamic perspective

Poverty, in Islamic perspective, is viewed not just from material side but also moral side, as well being has two sides: material and spiritual, which include mental peace, happiness and social harmony, then to realize it, it imposes justice and human brotherhood, without looking at gender, race, age *etc* (Chapra, 2008: 10, 2007: 6). In this point, Naqvi (2003: 119) points out that poverty has three dimensions, not just economics, but also moral - since it reduce the self respect -, social – because it pull the poor out from society - and political – due to the higher probability to create higher gap between society's social ranks. Islam has definite way to view richness, as the *Hadith* declares that "Richness does not lie in the abundance of worldly goods but richness is richness of the heart itself" (Mannan, 1986: 305). In conventional world view, this spiritual aspect is left behind and not included in the poverty aspect, although the conventional view take account of human aspect, such as freedom of choice, capability, *etc*.

The Islamic concept in economic (*muamalah*) highlights justice as one main point (Qur'an verse 57:25), it strongly emphasizes the importance of 'socio economic justice' and economic system which contain 'moral values' and 'moral filter' (Chapra, 1992: 239, 2007: 6-7). Although the conventional economic development argued it can achieve the goal without moral factor, however they are now admit dedication to 'development with justice' (Chapra, 2007: 7), but he continues to asserts that "…even material development with justice is not possible without moral development." because it "…requires an 'efficient' and equitable use of all resources…" and they cannot be accomplished "…without the injection of a moral dimension into economic pursuit.". This strong statement supports Islamic concept in economic development with the unique positive points offered, namely moral value, distinct from conventional economic development.

Islam persuades against severe inequality and poverty and it has a serious attention in poverty alleviation, *Shari'ah* (*Qur'an* and *hadith*) clearly touch that aspect (Ahmed, 2004: 21). Two verses of Qur'an (QS 7:10 and QS 62:10) and the prophet saying emphasize a personal obligation of a mankind to work and fulfil his needs through a well managed resource on earth, which is provided by Allah as a trust (*amanah*). Other verses of Qur'an (QS 70:24-25) states the importance of sharing the wealth with the needy to avoid large gap between the rich and the poor: "And those in whose wealth is recognised right, For the needy who asks, and him who is prevented (from some reason from asking)" (QS 70:24-25). The word 'right' implies that Islam strongly emphasizes the obligation of the society, particularly the rich, to contribute actively in poverty alleviation in the form of *zakah* and *awqaf* (Ahmed, 2004:22). *Zakah* is the obligation to pay certain amount of wealth to the poor, thus certain amount of the assets of the well-off individuals is expected to be returned to the society with the notion that it is the right of the poor (Ahmed, 2004: 22). On the other hand, *waqf* as an voluntary sector institution is an institutionalised charity aiming to deliver welfare services to the poor, it can be in the form of assets (such as land, building, car etc) or, becoming more commonly now, in cash *waqf*. In addition to the private sector contribution to in alleviating poverty, Siddiqi (1996: 12) emphasized the essential role of state for communal responsibility, as part of the "collective social duty" (*fard kifayah*) to help the poor. This means that poverty alleviation efforts can only achieve the maximum benefits to the poor if the community and the state are involved together actively in helping the needy through well managed pro-poor institutions, MEs empowerment will be one of these.

In more specific of looking at of what the poor needs as the cause of poverty, Obaidullah (2008b: 2-4) points out that they need access to financial services, particularly micro credit, to be able to pay for periodic incidences, urgent situation and investment. Therefore, due to lack of this financial access, they are put on a situation that force them to get a loan from informal market, who usually charge them a very high interest rates, that later on, often put them in the worse condition. Hence, Obaidullah (2008b: 4) argues that "Central to the challenge of ending poverty is creating wealth through development of micro enterprises", which then microfinance comes as an essential contribution to this wealth creation process. Therefore, Islam promotes economic empowerment, includes but not limited, by giving access to what the poor's needs, transformation of idle assets become income generating assets, capacity building, and transparent performance report (Obaidullah, 2008b: 17). Therefore, the concluding remark from Obaidullah (2008b: 23) identifies the comprehensive nature of poverty:

> Islamic approach to poverty alleviation is more inclusive than the conventional one. It provides for the basic condition of sustainable and successful microfinance, blending wealth creation with empathy for the poorest of the poor…also…composite of mission-based and market based interventions…. favors equity-based and cooperation-based models in contrast to mechanism that create and perpetuate debt.

Microfinance, particularly *Shari'ah* financing in micro credit for microenterprises, seems be able to offers a potential to poverty alleviation. Chapra (2008: 36) argues that "In the present-day world, microfinance has proved to have great potential for expanding employment and self-employment opportunities and needs to receive high priority in Muslim countries. Based on the CGAP best practices, Obaidullah (2008b: 11) asserts that "microfinance is a powerful tool to fight poverty".

Islamic microfinance

Microfinance refers to provision of financial services to the poor - more than just small loans, it also includes saving and micro insurance, as household might need credit but also they are able to save – with aim as development tool for its clients (Armendariz and Morduch, 2010: 15; Ledgerwood, 2000: 1). Initiated by Grameen Bank in Bangladesh, microfinance has reached success, however it has also been criticized since more cost to customers seems to be compelled when microfinance are forced to decrease cost and improve transparency (Armendariz and Morduch, 2010: 202). Islamic view also disapprove of this fixed high interest rates charge that get the poor into debt and difficulties (Obaidullah, 2008b: 10), hence, there are cases when the poor suffer the loss of their lands (Ahmed, 2002: 30). Thus, Islamic microfinance offers more feasible solution by offering not debt based approaced, but rather assets based approach.

Given specific characters derived from *Quran* and *hadiths* (saying of the Prophet), Islamic microfinance is provision of financial and non financial services based on Islamic values with aim to promote justice for all. Considering that Islam prefers community-based activities (Qur'an, 5:2), Islamic principles shape the nature of microfinance institutions as they operate under a group-based approach and joint liability. It can, therefore, be argued that the above characteristics seem to cover almost all aspects required by the poor. However, attention should be given to the implementation of the spirit of Islamic microfinance so that it is not just an empty theory; as the gap between the spirit and implementation is rather obvious.

Although Islam permits debt, but debt can only be allowed as the last source of fund (Quran, 7:31; 17: 26-27), and the Prophet advises the dangers of deep debt and he also strongly encourages full and on time repayment (Obaidullah, 2008b: 17). Islam commands mutual cooperation and unity as a fundamental rule (Quran verse 5:2), in this basis, group based financing and mutual guarantee within the group are accepted (Obaidullah, 2008b: 18). All business contracts must be *Shari'ah* compliant, free from *riba* and *gharar* (Obaidullah, 2008b: 19-22). Basically, there is no primary opposition in the global microfinance 'best practices' and the Islamic approach to poverty elimination (Obaidullah, 2008b: 22).

In comparison between Islamic microfinance and the conventional counterpart, both have similarities in terms of focused on economic development and social objective, aim to achieve a better life for whole people, support additional income, promote entrepreneurship, encourage risk sharing, believe that the poor should get involved in entrepreneurship activities (Obaidullah, 2008b: 10). Also, both are expected to rely on providing wider access to the poor, be a sustainable institution which can achieve "market based for profit approach", supported by efficient system and transparency reporting, with the focus on capacity building, combine with integration between microfinance and official financial system (Obaidullah, 2008b: 9-10).

However, the main difference is Islamic approach emphasizes on important points of provision of financing and non-financing services to improve microenterprises, transparency, understanding and cooperation (Obaidullah, 2008b: 10). Specifically, there are some differences as follows:

Table 1: Differences between Conventional and Islamic Microfinance

Category	**Conventional Microfinance**	**Islamic Microfinance**
Category of poor	One category	Two levels: 1. deeply poor who do not need loan but social safety net and charitable fund (*zakah*), 2. moderately poor who will be better of if they obtain credit for running microenterprises
Based of financing	Debt based and interest based approach	Profit and loss sharing (PLS) approach, free of interest (*riba*) and uncertainty (*gharar*)
Approach/target of empowerment	The poor and woman	The poorest and family
Sources of fund	External funds, saving of clients	External funds, saving of clients and Islamic charity fund.
Dealing with default	Group/centre pressure and threats	Group/centre/spouse guarantee, and Islamic ethics.
Social Development Program	Secular	Religious (behaviour, ethics and social

Source: Obaidullah (2008b: 11-12), Ahmed (2002: 41)

Thus, it can be concluded that the above similarities and un-similarities bring them to the same direction but contain different value, meaning and instruments.

The role of microfinance in fulfilling social and development requirements is essential. Asutay (2010: 29) argues that, as part of the whole financial system, IBF has a unique character and it should apply the Islamic values contained in the Islamic Moral Economy (IME). The intention of the IBF should be to achieve both economic and social objectives, and these social objectives cannot be separated from IBF due to its obligation to implement the IME, to achieve "human-centered economic development" (Asutay, 2010: 29). On the other hand, the criticism that IBF is operating in an environment similar to conventional banking and failing to realise its social responsibility cannot be ignored (Asutay, 2010: 25). However, as the objective function of microfinance - to act as a development tool through capacity-building - is aligned with Islamic values, Asutay (2010: 29) suggests that the most suitable method of implementing IME in IBF is by conducting social banking and Islamic microfinance (IMF). Therefore, IMF is considered as a fundamental part of IME and IBF due to its ability to implement the values of IME in reality, hence bringing the idea of development into existence.

In rationalising Islamic version of microfinance, it should be noted that the values and principles determine and essentialise the need to develop Islamic microfinance. In addition, conventional microfinance has been criticised because it is likely to charge its clients high interest rates; this is known as the debt-based approach, as they are dragged into debt (Asutay, 2010: 26). Islamic finance, hence, offers a moral approach through a profit and loss-sharing approach in the form of *musharakah* and *mudarabah* modes of financing (Asutay, 2010: 26) to prevent individual borrowers to be dragged into further debt. As IMF is based on asset-based approach as opposed to a debt-based approach, it is more appropriate for the needs of microenterprises, since their profits from their businesses can be hard to predict.

The providers of Islamic microfinance in micro level can be categorised as: (i) informal (individual such as friends, relatives, neighbours, moneylenders, saving collectors, pawnbroker, traders, processors and input suppliers and group (ROSCAs), (ii) member based-organisation, (iii) NGO, and (iv) formal institution (Obaidullah and Khan, 2008c: 23-24).

The operation of individual informal sector should follow *shariah* rules; only repay the original amount of loan (*qard hasan*), fee based (*ujrat*), *shariah* compliant pawn brokering (*al-rahn*) (Obaidullah and Khan, 2008c: 23). There are some disadvantages of this sector, such as: very high-priced, inflexible, high risk, less apparent, at risk to fail because of corruption, mismanagement and environmental catastrophes (Obaidullah and Khan, 2008c: 24). While member based organisation might include village bank, self-help groups (SHG), credit union, and finance cooperatives, Islamic NGO might include *zakah* and *sadaqah* (charity) based organisation with deeper social objective. Islamic banks fall under category of formal institution, having the most potential to provide inclusive financial system.

Islamic Microfinance provides *Shari'ah* compliant instruments for fund accumulation, financing, and risk management (Obaidullah and Khan, 2008c: 18-22), the following figure summarizes these instruments:

Table 2: *Shar'ah* Compliant Instruments

Shariah Instrument	**Forms**
Fund accumulation	a. charity (*zakah*, *sadaqah*, *awkaf*, gift that include *hiba* and *tabarru*) b. deposits (*wadiah*, *qard hasan* and *mudarabah*), c. equity (*musharakah*)
Financing	a. profit and loss sharing (PLS) (e.g. *mudarabah*, *musyarakah*), b. sale based mode (*murabahah*), c. lease-based modes (*ijarah*), d. caring loans (*qarn hasan*).
Risk	a. guarantee (*kafalah*), applied in group financing, b. collateral (*daman*) for individual financing and micro-takaful.

Source: Obaidullah and Khan (2008: 18-22)

It seems that these instruments cover the required instruments in the field, which can replaced what conventional microfinance offered in free interest perspective. Specifically, the characters of the above financing products are presented below:

Table 3. Financing Instruments

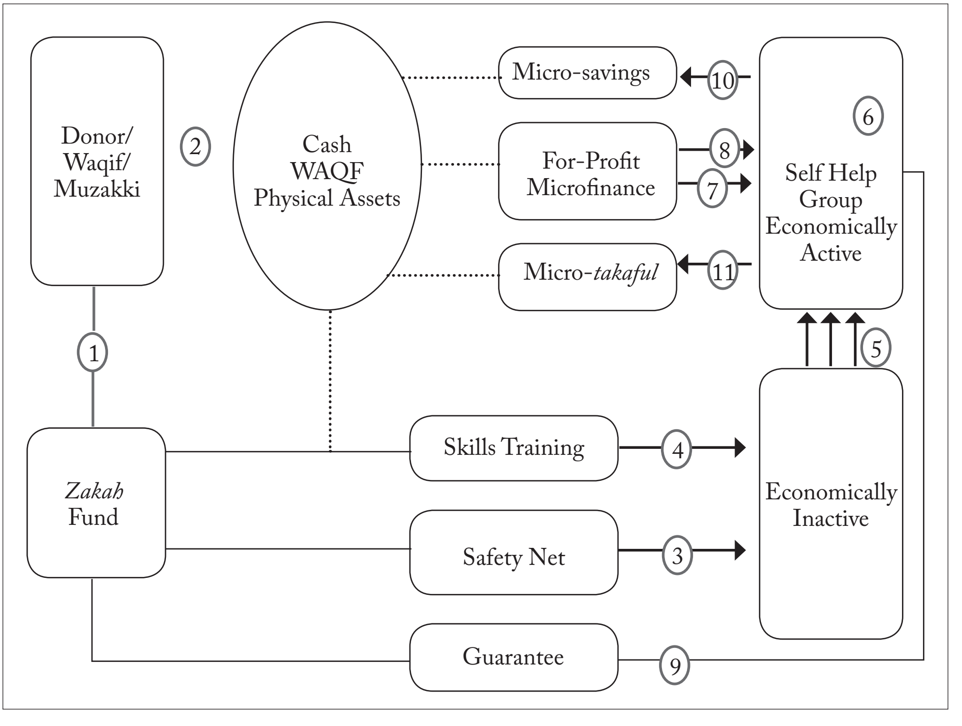
Instrument	Mechanism	Suitability	Risk to borrower	Risk to institution	Remarks
Mudarabah	Trustee partnership with pre-agreed ratio of profit sharing, the institution provide capital and borrower responsible to manage the fund in business.	Fixed assets purchased, working capital financing and project financing.	If loss, it has risk of un-rewarded work.	Full responsibility of capital loss.	It has complex operation with high operation, administrative and monitoring cost, require transparent and accountable reporting. Ideal mode of financing but hardly practiced.
Musharakah	Joint venture/ partnership contract, both participate in management and capital.	Fixed assets purchased, working capital financing and project financing.	If loss, share will be according to equity participation.	If loss, share will be according to equity participation	It has complex operation with high operation, administrative and monitoring cost, require transparent and accountable reporting. Ideal mode of financing but hardly practiced.
Murabahah (bai mu'ajjal)	Sale agreement with specified profit margin, payment can be in instalment or lump sum.	Fixed assets and working capital	Borrower can use asset and owned it in the end of period.	Institution has the asset ownership, hence it has risk and liabilities of assets.	More popular, simpler and easier to manage compared to *mudarabah/ musharakah*.
Ijarah	Leasing physical assets, institution is the owner of assets during *ijarah* period.	All income generating assets, particularly fixed assets.	Leased assets is a trust, no costs if the asset is damage beyond his control.	Institution has risk and liabilities of assets ownership.	Lower administration and monitoring cost and simple operation, could be adopted by conventional microfinance.
Qard Hasan	Loan with zero nominal return.	All purposes (consumption/ productive).	Very low	Very low	The purest financing with the main purpose is only charity and helping the poor.

Source: Obaidullah (2008b), Dusuki (2008) and (Dhumale and Sapcanin, 1999).

Among the above instruments, *murabahah*, *mudarabah* and *qard hasan* seems to be the most practical and suitable scheme due to easier operation and monitoring of equal instalment derived from buy-resell model (Dhumale and Sapcanin, 1999).

Methods in Islamic microfinance might include: composite model of Islamic microfinance (Obaidullah, 2008b: 54), *wakalah* agency model, *mudarabah* agency model (Wilson, 2007), and SPV model (Dusuki, 2008). Composite model, as depicted in Figure 1, works in the activities as follows: (i) Donor create *zakah* fund; (ii) *waqf* fund based in physical and cash is build; (iii) The poorest who are economically inactive will get *zakah* fund as safety net; (iv) Skills training are delivered for the poorest using physical assets from *waqf*; (v) Skills improvement will encourage the poorest to graduate from poverty and become economically active; (vi) They are formed in self help groups with mutual guarantee; (vii) Allocated fund based on combination for profit debt based and equity based modes; (viii) Loan repayment, with possibilities of higher loan in the future; (ix) *zakah* fund is used to guarantee against default; (x) Saving is encouraged under micro-savings; (xi) *takaful* fund is encouraged to protect against risks and uncertainties (Obaidullah, 2008b: 53-55).

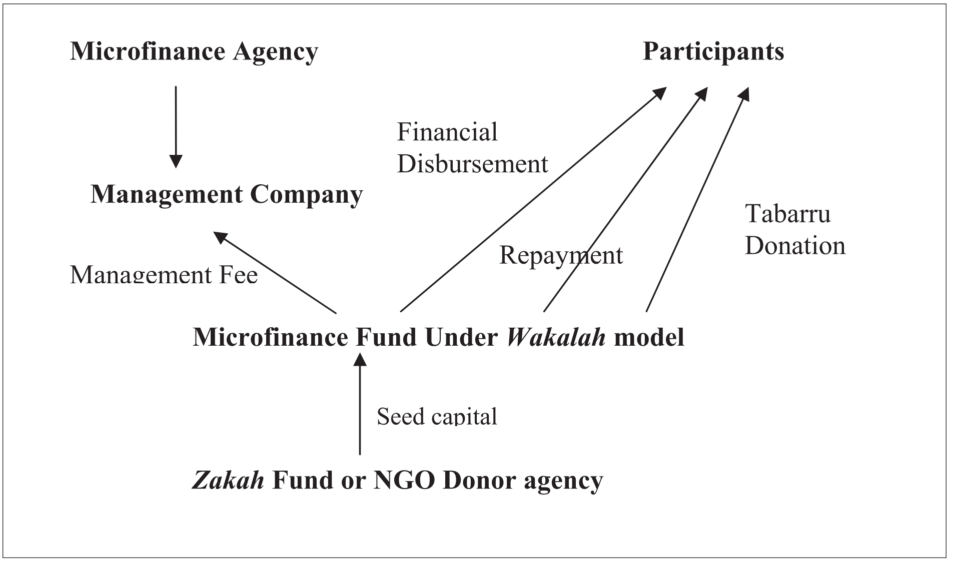
Figure 1: Composite Model of Islamic Microfinance



Source: Obaidullah (2000b: 54)

Wakalah model, as depicted in Figure 2, utilizes fund from *zakah* and NGO donor, distributed to the poor in *qard hasan*, hence, *zakah* is promoted as self sustaining development tool for the needy, and educate them to be independent (Wilson, 2007-210). The management company act as agency and assesses the eligible credit application. For this duty, a fixed fee, not the share of *wakalah* fund, set up for management as reward of conducting the operation. The participants could get fund disbursement, but with rationing mechanism and prioritization to prevent mass of capital be taken out. In this case, it is similar to credit union, but with qualified financial administration and protection for clients. This model widely used in Islamic *takaful* insurance, as it having donation of *tabarru* (solidarity) fund as revenue accumulation to help other participants. Other revenues gathered through management fee based services (*jualah*).

Figure 2: Wakalah Agency Model

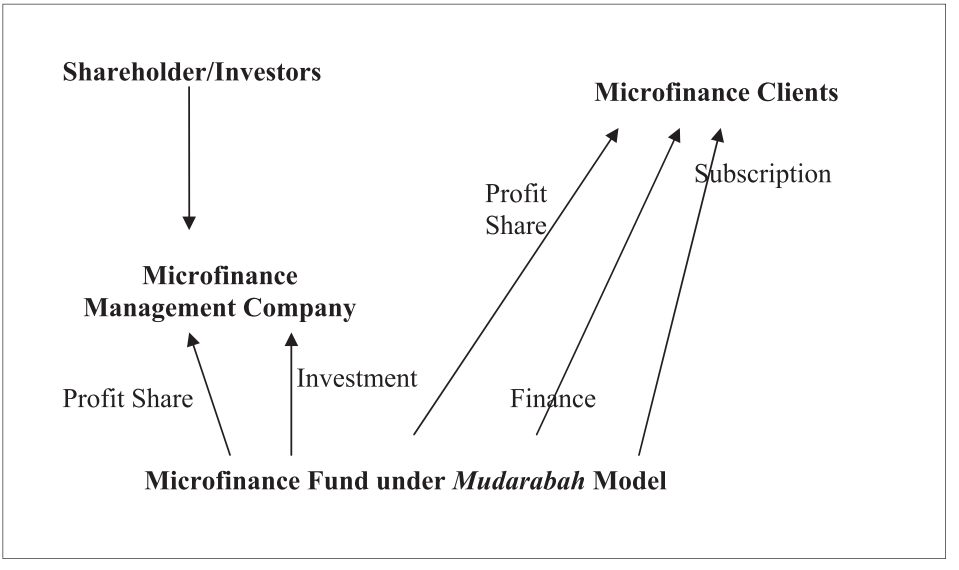


Source: Wilson (2007: 204)

Mudarabah model, as depicted in Figure 3, works differently compared to *wakalah* model as it is based on profit and loss sharing contract (Wilson, 2007: 211). In this model, company acts as financier (*Rabb al mal*), invest the fund to client (*mudharib*) and get pre-determined ratio of profit share as return, in which similar to joint venture. Hence, due to the fluctuation of actual profit, the amount of share will fluctuate. If there is loss, the bank will liable for not getting the fund back and clients has risk of not obtaining rewards for the works done in running the business. *Zakah* fund could not be used in this method because the nature is more commercial rather than social. The issue in this method, as in conventional also, is asymmetric information – due to difficulties to get information about clients' liability - and moral hazard in the case of misuse of fund.

Overall, Wilson (2007) underlines that microfinance services should be provided by specialised financial institutions rather than Islamic banks.

Figure 3: *Mudarabah* model



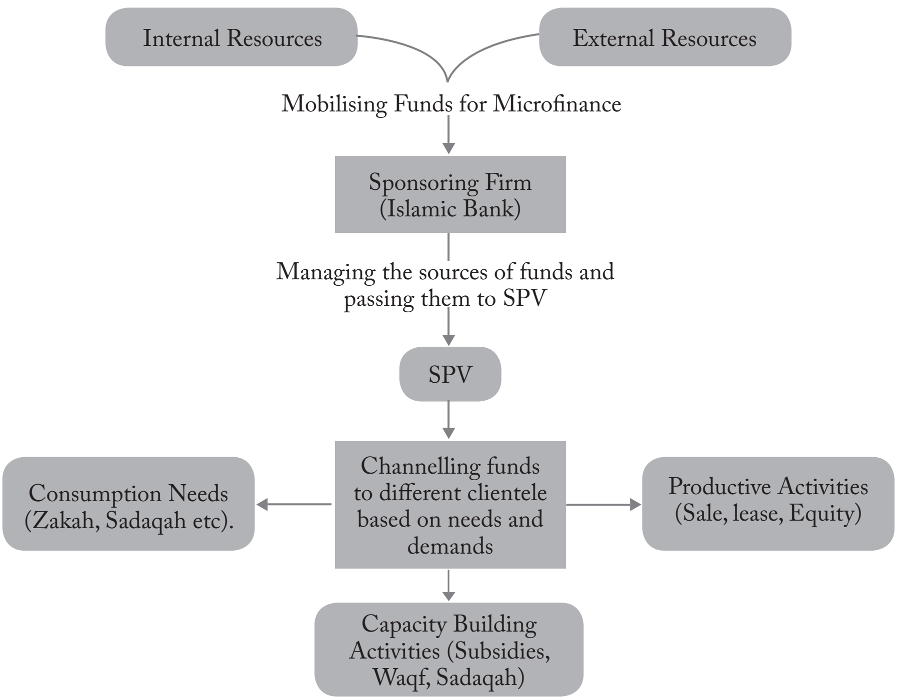
Source: Wilson (2007: 211)

In contrast to Wilson's concept, Ahmed (2012) has recently proposed two models of Islamic microfinance organisation. First, Islamic banks could manage Islamic microfinance through the establishment of a microfinance division, which applies the same format of group-based financing and weekly repayments. This proposal is based on the argument that Islamic banks have more capable staff to manage financing, and a large number of branches/networking which might reduce administration costs; hence Islamic banks' operation of Islamic microfinance is likely to be more effective than that of Islamic MFIs (Ahmed, 2012: 25-26). Furthermore, the economic viability of Islamic banking is likely to be higher compared to Islamic MFIs in terms of available funds and lower operational costs due to its wider operation. Subsequently, micro financing and social services could be provided with more effective and efficient management.

Second, there is a potential to develop the provision of Islamic micro financing through traditional Islamic instruments such as *zakah, waqf*, *qard hasan* and *sadaqat* (Ahmed, 2012: 27-29). Currently, researchers have become increasingly interested in the implementation of this concept. Aligned with this concept, Zarka (2012) argues that microfinance should be provided by *waqf* institutions rather than Islamic banks. In his scheme, he suggests the establishment of a guarantor of liquidity and a guarantor of losses with the purpose of strengthening the security of funds; hence, this is expected to contribute to the improvement of credit standing (Zarka, 2012. : 78-79).

SPV model shown in Figure 4 is proposed by Dusuki as an alternative, which have the following features: (i) a variety of fund sources with specific microfinance intention are mobilised by Islamic Banks, (ii) a bankruptcy-remote SPV is created, (iii) certain amounts of funds are allocated and forwarded to SPV, (iv) the funds are distributed to based on clients' demand (Dusuki, 2008: 61).

Figure 4: SPV Model



Source: Dusuki (2008: 62).

It can, therefore, be summarised from the above models that Islamic microfinance maintains the basic format of conventional microfinance in terms of weekly/monthly repayments and social development programmes. However, Islamic microfinance has more opportunities to use other external funds from charities (*zakah, waqfs*), the mode of financing is more varied to accommodate the different needs of the poor, and the approach in dealing with default is softer.

Performance and Impact of Islamic Microfinance on Poverty Alleviation

Provision of financial access to poor people will enable them to increase their income and economic wellbeing, develop assets and reduce weaknesses (Obaidullah, 2008b: 4) by empowering them with the objective of developing functioning and enabled individuals (Sen, 2001: 177-178). The lack of financial access seems to be the main reason for their inability to become involved in development (Obaidullah, 2008b: 4).

Islamic MFIs might be able to alleviate poverty because they are not debt-based; hence, they will not drag their clients into an even worse situation. Islamic teaching also encourages the waiving of credit if clients are in deep trouble.

The performance of Islamic microfinance has been quite promising. Obaidullah (2008a: 23) argues that the performance of RDS (Rural Development Scheme) of IBBL was better in terms of growth (12.5%), drop out rate (5%), and operational efficiency as compared to three conventional leaders in microfinance; Grameen Bank, ASA (Association for Social Advancement), BRAC (Bangladesh Rural Advancement Committee). Having lower rate of return charged (10% with 2.5% rebate for on time payment) than other microfinance (16% to 22.5% of interest), this offers advantage for the poor (Obaidullah, 2008a: 23-24). This microfinance also offers active spiritual development program with the purpose to improve members' awareness of social right and responsibility in order to improve better relationship with others (Obaidullah, 2008a: 19), the program which has not been provided by conventional microfinance.

However, different view presented by Seibel (2005), as he located certain problems that Islamic microfinance in Indonesia has low assets compared to conventional banking due to the lack of regulatory and supervisory aspects in Islamic values. The two proposed options are: to pay attention completely on Islamic commercial banks and "establishment of branch networks with Islamic microfinance products"; and 2) to reassess the challenges and realistic opportunities for Islamic rural banks and cooperatives" (Seibel, 2005: 41). Although this finding might be true in the specific research area, but it could not be generalised in all area of this country, as Obaidullah (2008a: 53-54) maintains that the BMT (*Baitul Maal wat Tamweel*/Islamic Cooperative) in Indonesia provides successful story in linkage program between group of microenterprises, BMT and Islamic Banks. Given the ability to cooperate with the poor the surrounding area, BMT seems to be the most proper institution to serve the poor (Ascarya and Sanrego, 2007)

Concerning the impacts of Islamic microfinance, it can be discussed into two areas: economic and social aspect. In general, it is expected that provision of financial access to poor people will enable them to increase their income and economic wellbeing, develop assets, decrease weaknesses, and get involve in development (Obaidullah, 2008b: 4). The latest economic impact presented by empirical study of IBBL's (Islamic Bank Bangladesh Limited) impact on rural poverty finds that loans affected considerably in improving household earnings, output of harvest and cattle, disbursement and employment (Rahman and Ahmad, 2010: 177 - 179). In particular, based on field survey of 1,024 respondents, Rahman and Ahmad (2010: 177-178) finds that the family income increased by more than 33%, the expenditure for health increases 50%, family employment increased from 1.91 to 2.1 working members, all types of assets has also increased. Moreover, the impressive economic impact based on the study of three Islamic Microfinance Institutions in Bangladesh explored by Ahmed (2002: 53), as he finds the economic impacts in increasing: time spend on productive activities by beneficiaries and other family members output of economic activity, particularly in improving amount of goods/services, innovation of new product, increasing assets and other properties. These economic aspects might imply that Islamic microfinance has an advantage to offer, although it still has weaknesses to be overcome.

Recently, a study by Shirazi (2012: 20) finds poor borrowers are most benefited as compared to the non-poor borrowers in terms of income growth (2% and 6%), as based on the data from Pakistan Poverty Alleviation Fund in 2005 covering 3,000 household. In addition, the most recent study on the economic impact of IsMFIs in Thailand suggests that IsMFIs has positively contributed to increase the customers' welfare (Naipom, 2013).

In particular to the economic impact of micro financing, Naipom (2013: 190) argues that gender, annual household income, age, total land size, membership length and occupation contribute to the impact factors. These economic aspects might imply that Islamic microfinance has an advantage to offer, although it still has weaknesses to overcome.

Social impacts might include improvement of Islamic knowledge and relationship with others, health. Rahman and Ahmad (2010: 180) find that the health awareness of the respondents increase in term of increasing number of people consume quality drinking water and using quality latrine for sanitation (17.91%). Besides, the clients also have positive opinions towards improvement of their skills and social and economic well being (Rahman and Ahmad, 2010: 186). Ahmed (2002: 55) also reveals that beneficiaries of Islamic microfinance not only get financial advantages, but also improvement of other aspects through social development programs: improvement of Islamic knowledge, improving relationship with spouses and other group members. Based on these two studies, it can be implied that Islamic microfinance has consider social aspects, although more attention should be emphasized.

In overall, on the basis of the above studies, it can be inferred that Islamic microfinance has considerable social aspects, although it requires more attention. Hence, in order to have a wider impact, Dusuki (2008: 58) argues that microfinance should provide market-based services, creativity to innovate new programmes and product differentiation, efficient operation, and broader outreach, offering not only productive loans but also loans for consumption purposes to cover the cost of health, education and social responsibility.

Conclusion

Islamic microfinance, as a relatively young industry, provides services particularly to meet the demand of a specific market whose members cannot accept the conventional financing product due to their adherence to Islamic principles. Thus, Islamic Micro Finance should be considered contributing to poverty alleviation, financial development and also financial inclusion because it offers unique characteristics with rich of values and human oriented. In practice, it has interest free approach; hence, it will not drag clients to debt trap and worse condition.

The performances of Islamic microfinance in general are quite promising. Evidences from the impacts studies also provide good results on how Islamic microfinance can improve economic and social well being of the clients, although in certain areas improvement is still required, particularly dealing with improvement of regulation and provision of trainings in social development both for institution's employees and borrowers.

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Corporate Social Responsibility from an Islamic Moral Economy Perspective: A Literature Survey

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Abstract

Islamic finance re-emerged in modern times as an alternative ethical financial proposition shaped with the norms and principles of Islam. In this new construct not only the 'form' or the legality of the financial instruments and operations are considered, but Islamic moral economy foundations of Islamic finance necessitates that Islamic norms must be integrated as 'substance' in financial activity. This is considered as the distinguishing point of Islamic finance, and is also the meaning of the suffix 'Islam' in Islamic finance. The substance, hence, refers to real economic activity, observing social good, contributing to human and economic development, and enhancing and protecting individual, society and environment. In modern times, this is considered as 'corporate social responsibility' (CSR), which has always remained an integral part of the Islamic moral economy as an inevitable ontological reality. This paper, hence, aims to explore and identify the CSR nature of Islamic finance; and also argues that Islamic finance institutions, therefore, have to pay due importance to social and developmentalist objectives in their operations; and therefore should be concerned with the 'consequences' of their financings with the objective of mitigating or moderating the 'observed' social failure of Islamic finance and banking institutions.

Introduction

Islamic moral economy (IME) offers a new paradigm in which moral is endogenised into the economic and financial thinking in an integrated manner; and therefore, it provides a moral filter through which economic

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and financial choices as part of behavioural norms can be made according to the Islamic teaching. The concept of CSR, hence, by definition is considered as an integral part of IME due to the ontological reasoning of Islamic teachings in which social justice and social good is prioritized. In other words, the IME paradigm with its axioms and principles has direct implications and provides rationale for CSR in organisations through articulating the ideals of IME in personal and organisational levels.

Since Islamic Financial Institutions (IFIs) are considered as financing and operational tools of IME paradigm, the business sector including IFIs working within the IME paradigm are expected to function in essentialising and also prioritising the CSR by also considering the social outcomes of their operations in terms of social welfare, natural recourses and the environment in their attempt to fulfil their social responsibilities towards society. This is esentialised through IME, as Islamic banks are expected to work within the objective function defined by maqasid al-*Shariah* objective aiming to promote social well-being through maintaining justice. In other words, IFIs by definition are expected to "consciously align their decisions and actions so that these are 'socially responsible'" (Sairally, 2005: 1).

The notion of CSR in Islam in addition to stakeholder's duties and their interests also includes moral obligations. Thus, CSR from an Islamic perspective, as part of the new paradigm is an endogenous concept and expected to be in IFIs' agenda.

It should be noted that the epistemological and ontological sources of the Islamic thought, the *Quran* and *Sunnah* have a clear emphasis on human responsibilities towards other individuals, society and environment. In addition, faithful observance of social responsibility and Islamic moral values encourages trustful and pleasant relations among people "and motivate them to fulfill their mutual obligations promoting family and social solidarity, tolerance and peaceful coexistence" (Chapra, 2008:12) as part of CSR in everyday life implying that human is the essential base of CSR and therefore human beings, developed with such Islamic consciousness. will be able to conducts ethical behaviour in every aspect of life including in their business life and business organisations.

Despite such an aspirational worldview articulated by IME, in the reality the situation is not that optimistic and critics argue that IFIs have not been able to fulfil the aspirations of IME as they no longer attach to the spirit and the nature of the moral economy. This is also observed in the way Islamic banks convergence towards their conventional counterparts in terms of objective function but also operations. As a result, the social failure of IFIs has been observed (Asutay, 2012). In other words, a divergence between the principles and ideals of Islamic moral economy and course taken by the professional operations of IBF has set in since 1990s when the internationalisation of IBFs has become a reality. However, it is suggested that IME can be offered as one of the remedies for the social failure of Islamic finance (Asutay, 2009: 24).

In responding to these issues with the objective of rendering a comprehensive understanding of CSR through the IME, this paper delineates the aforementioned arguments and therefore, starts with an introduction to IME and its axioms. It presents the rationale for 'social' in IME by referring to ontological and epistemological sources. As the aim of foundational principles and axioms of IME is to pinpoint the principles of IBF, this paper identifies these principles and relates to CSR in a consequential manner. After highlighting the role of IFIs in IME as socially responsible to society, various theories in relation to the concept of CSR from Islamic perspective are discussed. The chapter concludes with highlighting the ongoing debates on the divergence of IBF practices from the aspirational position of IME and hence Islamic CSR and the necessity of going back to the basics through revising the philosophy of IME based on the authentic principles of Islamic teachings.

Conceptual Definitions of CSR

CSR can be expressed in different ways. The social responsibility of business can be described as transparent business actions that are based on ethical values, respect for people, communities, and environment and at the same time comply with legal requirements. Socially responsible companies have a positive and productive impact on society. By and large, CSR is about how companies manage the business processes to produce an overall positive impact on society. In addition, social responsibility plays a considerable role in creating a cleaner environment (European Commission, 2001: 5). According to Aras and Crowther (2009: xxi), the concept of CSR is related to business contribution to social development and social behaviours of employees.

Ward (2008: 9) stresses that business has become an integral part of society and the role of CSR is to analyse how efficiently business tackles social issues and to increase socially beneficial decisions of companies. The

European Union highlights the voluntary nature of CSR by defining it as "a concept whereby companies integrate social and environmental concerns in their business operations and in their interactions with their stakeholders on a voluntary basis" (cited in Hopkins, 2004: 6). On the other hand, during the UNRISD conference in Geneva, in 2003, several discussions revealed the need of regulatory approach in the CSR movement to implement better CSR strategies (UNRISD, 2003: 3).

Different corporations have framed different definitions of CSR depending on the institutional and political contexts in which they operate. Therefore, according to Marrewijk (2003: 96), contemporary conceptual definitions of CSR are rather subjective. As a consequence,

> CSR is a very slippery concept with shifting definitions, but at very least involves a company going beyond its strict legal obligations to take into account the impact its business has on stakeholders other than its shareholder. (Corkin, 2008: 39)

Despite the plethora of literature on CSR, due to the substantial public and academic interests in the subject, the good understanding of the subject still does not exist and this creates additional difficulties to the contemporary definition of CSR. First of all, the scope of CSR is very wide to be applicable to corporations (Marrewijk, 2003: 96). Secondly, there is no general agreement of terms that gives a source for CSR initiatives (Marrewijk, 2003: 96). Thus, the variability of concepts and lack of comprehensive research hinder a dialogue between academicians and practitioners. Furthermore, the existing literature largely highlights the positive impacts of CSR on business, whereas a small number of studies examines the price of CSR initiatives and the correlation of social responsibility and business (Vogel, 2005:11). Although CSR means the voluntary behaviour of business towards stakeholders, companies face several problems while deciding how to meet the requirements and hopes of different stakeholders and at the same time do not neglect shareholder issues. The reporting criteria of socially responsible practices as well as the choice of the best CSR initiatives are important and complicated (Aras and Crowther, 2009: xxi).

In spite of the fact that "CSR is confusing" (Webb, 2002: 3 as cited in Hopkins, 2004: 2) and its concept is surrounded by numerous ambiguities, media and the modern commercial era influence business entities to be more involved in the promotion of social development matters (Balabanis et al., 1998: 25) as organisations function in a "shared environment" and it is assumed that they should adopt CSR principles (Sairally, 2006: 14 taken from Preston and Post, 1975).

In addition, organisations perceive to have strong CSR commitment due to the fact that being "an integrated part of society and community" brings about moral and ethical rules (Azid *et. al*, 2007: 1). Apart from the economic obligations, firms are compelled to care and support the interests of all the elements of the firm and society. It is assumed that in order to meet economic goals and their responsibilities towards stakeholders and large environment, organisations should function and grow in a corporate governance framework, which aims "to align as nearly as possible the interests of individuals, corporations and society" (Sir Adrian Cadbury in 'Global Corporate Governance Forum', World Bank, 2000). This indeed rationalises the need for CSR in the financial and business world.

Islamic Moral Economy as the Basis of CSR

IME in its modern context emerged in the beginning of 1970s, as a respond of Muslim intellectuals to the failure of capitalist and socialist development strategies in the Muslim world (Asutay, 2007a: 169-170). Therefore, IME came as "a modern definition of divinely ordered rules and principles related to economic and financial activities, instruments, contracts and choices" (Asutay, 2010: 35).

As opposed to the self-centered behaviour, rationalism and the maximisation of an individual's utility as assumed by the prevailing systems, IME aims to develop socio-tropic individual through norms and moral understanding, where individuals consider their own interests as well as social 'good' and conduct their business affairs within the bounds of Islamic principles in also taking into account of social environment and hereafter. Furthermore, the issue of maximising the prosperity of any individual in Islamic economics is parallel to maximising welfare of the community with the consideration of hereafter (Asutay, 2007a: 171), as *ihsan*, or beneficence is considered an essential part of human life as the axioms of Islamic economics states.

Moral values that are integrated into IME make this paradigm different from the conventional economics, explicit framework of which is based on justice, equity, human dignity, freedom and moderation in everyday life including economics and financial transactions. As an economic policy framework also, IME focuses on development and management of economic resources in order to fulfil spiritual, social and essential material needs of society in developing a holistic approach to economic and financial issues. Additionally, IME prioritises a moral duty on human beings to provide opportunities for those living in poverty through redistribution of wealth. In fact, Islamic economic paradigm "aims at producing disciplined or morally filtered economics and financing which should not lead the individuals, but rather should be led by individuals as regulated by the moral economy principles of Islam" (Asutay, 2010: 36). Thus, the strong implication of moral dimension in economic and financial life as proposed by IME entails several conditions such as ensuring social justice, social development and environmental protection, maintaining nature and humanity in harmony, the prohibition of taking and receiving interest.

It should be noted that the existing voluminous literature on Islamic economics shows a tendency to advocate socio-economic goals of the system, particularly, *adalah* or social justice and *haqq* or right perspective, enhancement of human well-being and social equity, and poverty reduction. The socio-economic goals of the IME are perfectly outlined by one of the fathers of the Islamic economics paradigm, Siddiqi (1980: 22) as follows:

(i) Enhancing human well-being;
(ii) Reaching sufficiency and harmony in society as well eliminating poverty and fear;
(iii) Meeting basic needs of individuals;
(iv) Providing the higher quality in life and better place to live and optimising the use of available resources;
(v) Fulfilling spiritual need of society;
(vi) Establishing economic and social justice as well as maintaining background for equality of opportunity and cooperation;
(vii) Encouraging universal brotherhood and justice as well as distribution of national income and freedom in accordance with the principles of justice and equity and the context of social welfare.

As can be seen, IME offers a new paradigm in which moral is endogenised into the economic and financial thinking in an integrated manner; and therefore, it provides a moral filter through which economic and financial choices can be made according to the Islamic norms. This provides a rationale and motivation for a sustainable and CSR oriented economic paradigm by endogenising all the stakeholders in a society.

Axiomatic Foundations of Islamic Moral Economy in Rationalising CSR

It is worth mentioning that the philosophical foundations of Islamic economics are completely distinct from the core theoretical issues of other conventional systems due to the fact that Islamic economics is based on strong moral values derived from the ontological sources of Islam, namely Qur'an and the tradition of the Prophet. The conceptual foundations or axioms, as Asutay (2007b: 7) states, have been established by the intellectual efforts of leading academic theoreticians in the field, such as Chapra (1999; 2000), Naqvi (1981; 1994), Siddiqi (1981), El-Ghazali (1994), Ahmad (1980; 1994; 2003) and Sirageldin (2002).

Naqvi (2003: 149-157), in particular, while discussing the theoretical fundamentals of Islamic economics, refers to *tawhid* (God's unity), *al'adl wa'- ihsan* (equilibrium), *ikhtiyar* (free will) and *fard* (responsibility). These concepts were further expanded through the addition of *rububiyyah, khilafah* and *maqasid-al Shari'ah* by Arif (1989) and Ahmad (1979; 1994) (Asutay, 2007b).

It is suggested that the implications of these axioms on the economic system might positively affect individual's behaviour and make their contributions to society more meaningful thereby the economy will achieve socio-economic justice. In other words, the axioms through which foundations of IME is developed helps individuals to endogenise social good and justice in their objective functions.

IME is defined by these philosophical foundations as an ideal to analyse the causes of economic and social problems and find practical solutions that suit modern societies within the context of the doctrines of Islam.

IME assumes following philosophical foundations:

(i) *Tawhid* (God's unity and sovereignty) is the recognition of the oneness of God. IME is founded upon the vertical ethicality manifested by *Tawhid*. As an initial part of social justice, vertical ethicality means that all individuals are equal in the sights of God, which also includes accountability to God, who is worthy of absolute worship and this requires humans to be conscious of their actions (Naqvi, 1994: 26) as it is the belief and relationship between human and the Creator (Naqvi, 2003:150). *Tawhid*, as a fundamental element of the IME, refers to the freedom of deeds wherein every human being is regarded as an essential part of the entire system. As an axiom, *tawhid* establishes the norms for economic and business activities from an Islamic point of view by not only focusing the consequences of economic activities in this world but also their repercussions in the hereafter and hence brings 'spiritual accountability' into the equation to establish social equilibrium in the society through the economic and financial means

It is important to note that *tawhid* provides an objective function for human life and gives meaning to human life, and this objective function is determined by *falah* or salvation or happiness. However, as a dynamic system IME extends the *falah* through spiritual accountability as two-dimensional: happiness in this world and in the hereafter.

(ii) *Al-'adl wa'l-ihsan* (Equilibrium and Beneficence-Socio-Economic Justice) is another significant axiom of IME, where individuals are obliged to contribute in establishing justice (*'adl*) and promoting beneficence (*ihsan),* which accordingly lead to the manifestation of socio-economic justice. Basically, this axiom alongside with *Tawhid* means that each human being in this life should receive what he/she deserves as well as achieve high life standards on both personal and social levels (*hayat al-tayyebah).* As the horizontal equality that lies in this conceptual foundation provides all elements of the fundamental base of the social, legal, political and economic organisations in actualizing justice. In addition, *adalah* as an axiom of social justice and beneficence, necessitates that individuals and societies are supposed to set up a balance between current and forthcoming needs of the generations as well as develop strategies to meet the requirements of human beings. Furthermore, it articulates that individuals to attain a higher level of life and develop suitable methods that ensure fair income and wealth distribution within the stability and sustainable development policies (Asutay, 2007b: 7).

(iii) *Ikhtiyar* (Free will): Islamic economic systems aims to guarantee individual liberty and freedom of choice of opportunities. Individuals are free to decide how to use their own capabilities and economic resources, which is the essential part of an economic structure but also is an essential instrument of *adalah* as without freedom justice cannot be realized. On the other hand, it seeks to provide effective moral filters at different levels of life and activity. Therefore, although there is a free will (*ikhtiyar*) given to individuals to choose whatever path they desire to follow, they have a responsibility as a *fard* towards themselves, society and the Creator (Naqvi, 2003:157)

(iv) *Fard* (Responsibility) aims not to leave the social justice related matters to individual choices, as IME through this axiom aims to make some of the social justice oriented arrangements as mandatory. This suggests being responsible or to benefit society at large (Asutay, 2007b: 7-8) through not only voluntary action but also mandatory action aims to make sure that *adalah* can be established.

(v) *Rububiyyah* as one of the significant conceptual foundations of IME demonstrates that individuals are obliged to show respect to the divine arrangements in broad social and environmental concept for nourishment, allowing to direct, reach, and to sustain things to their perfection (Ahmad, 1979: 12). This refers to the importance of sustainable development to maintain harmonious relations between different spheres of life.

(vi) *Tazkiyah* (Purification plus growth) refers to growth with harmony and hence implies sustainable development, which assumes that Islamic communities will preserve "their fundamental, internal balances while undergoing various processes of change" (Sardar, 1997: 51). This economic axiom has come as a result of combination of *tawhid*, *adl*, *fard*, and *rubibiyah* since it leads individuals to develop fully their human potentials in addition to harmonious social and economic development, which should be conducted with ethical and moral considerations. Consequently, "the result of tazkiyah is *falah*, prosperity in this world and the hereafter" (Ahmad, 1994: 20, cited in Asutay, 2007b: 8).

(vii) *Khilafah and human accountability before God (khalifa* or individual's role as God's vicegerent on earth). This indicates that humankind is the representative of Allah on earth, therefore, "Allah has entrusted mankind with stewardship of Allah's possession" (Farook, 2007: 33). This axiom identifies the role and status of human being, specifies his/her duties as a Muslim and a part of the entire Muslim community and "the reasons of the existence of the individual" (Asutay, 2007b: 8). An individual's role as *khalifah* requires him/her to achieve *falah* but also create an environment through which others also can reach *falah*, therefore, an individual is entailed to work and contemplate in an integrated manner.

This axiom is a direct consequence of the pillar of the sovereignty of God as it explains one's aim and behaviour of providing social welfare and justice as a crucial element of faith (Mohammed, 2007: 109). Thus, in order to function according to the identified foundational axioms, IME imagines and considers a *khalifah* human being in the sense of *homoIslamicus*. The practical implications of the concept of *khilafah* are "universal solidarity, sustainable consumption of resources, which are trust from God, pursuing a humble life-style, and having human freedoms to conduct daily life" (Asutay, 2007b: 8).

Thus, the aforementioned foundational axioms of IME aims at having imagined individuals who are accountable for their actions, concerned with the interests of the society as a totality in an integrated manner. Additionally, and most importantly, is the concept of *khalifah*, which is translated as vicegerency of God on earth, which is a role given to individual humans by God. This can be termed as *homoislamicus* (as opposed to the *homoeconomicus*) as an individual who have immersed these axioms in his or her life by fulfilling the roles and duties expected. This is what distinguishes the Islamic methodology from the neo-classical economic methodology, where the ultimate end result will be self-development of individuals and subsequently harmonious development of the overall economy and ultimately ending in *falah* (success, happiness and well-being). As a consequence, the direct implication of this would be the creation of moral economy away from the highly materialised and financialised economy.

(viii) *Maqasid al-Shariah* (objectives of the *Shariah*) provides the moral and legal framework in giving meaning to the axioms, which states that the objective of *Shari'ah* is to promote human well-being in serving the ultimate goals and objectives of religion. In other words, whatever the effort is dispensed must be for human well-being. The early interpretations of *maqasid al-Shari'ah* by al-Ghazali, defines it as "promoting the well-being of all mankind, which lies in safeguarding their faith (*din*), their human self (*nafs*), their intellect (*`aql*), their posterity (*nasl*) and their wealth (*mal*)" (Chapra 2000: 118). Thus, *maqasid al-Shariah,* with its unchanging moral framework and flexible and dynamic approach, presents spiritual guidelines for personal, social, political, economic and intellectual activities of human beings (Dusuki, 2005: 45, taken from Sardar, 2003). The substance or the epistemology of *maqasid al-Shari'ah* comes from concepts such as *aqidah*, *akhlaq* and *fiqh* are the key elements of *Shari'ah*, where *aqidah* refers to creed or a religious belief system; *akhlaq* is the practice of virtue and manners;

fiqh is the set of legal principles that deals with the actions of individuals.

The interpretation of the concept of *Maqasid al- Shariah* was enlarged by Ibn Khayyum through expanding the horizon of IME to be more involved with increasing public interests in order to be able to tackle issues such as poverty and inequality, where some methods based on Islamic law could not successfully deal with. Accordingly, Islamic moral principles regard the individual welfare to be parallel to the common interests, which broadens the limited definitional margins of Islamic law (Asutay, 2007b: 9). In different words, this assists to establish an economic discipline with an emphasis to the objectives of Islam as a comprehensive way of life rather with an emphasis on the objectives of Islamic law (Siddiqi, 2004).

As a result, the abovementioned ethical axioms derived from ontological and epistemological sources of Islamic teachings form the foundation of a moral-based Islamic economic system and provide the fundamental framework, which aims "to maintain a balance between today's and tomorrow's consumption, and to maintain an equitable distribution of wealth and income" (Sirageldin, 1995: 465).

The most important or distinguishing feature of IME, as can be seen, is the obligatory existence of an 'Islamic moral filter' in individual, social and organisational level through which business activities should take place (Sirageldin, 1995: 464) within the framework of Islamic ethics as an integral part of the Islamic faith having implications for all spheres of individuals' lives including business dealings and obligations.

The IME paradigm with its axiom and principles has direct implications and provides rationale for the CSR through embedding the ideals of IME in personal and organizational level. For this, the business sector including IFIs working within the IME paradigm are expected to function in essentialising and also prioritizing the CSR by focusing on social welfare, considering natural recourses and the environment in their attempt to fulfil their social responsibilities towards society as they aim to accomplish the main *Shari'ah* objective of promoting social well-being though maintaining justice.

The notion of CSR from an Islamic perspective does not only entail stakeholders' duties and their material interests, it also entails moral obligations. Therefore, CSR, as a part of Islamic framework paradigm, is not an exogenous concept, which is expected to be apparent in IFIs; on the contrary, it is "firmly inscribed within the religious bond" (Dusuki, 2008:14). In the epistemological and ontological sources of Islam, the clear emphasis of human responsibilities towards the environment in general and its living creatures in specific can be found as an attempt to reach social justice on planet earth as well as the social justice in relation to individual and social environment. Furthermore, faithful observance of social responsibility and imposed Islamic moral values encourages trustful and pleasant relations among people "and motivate them to fulfill their mutual obligations promoting family and social solidarity, tolerance and peaceful coexistence" (Chapra, 2007:15).

IME, thus, aims to create its own institutions to respond to economic and financial needs of the society in which it operates, which includes financial institutions. However, they are considered as part of the ethical paradigm of IME and therefore are expected to contribute to socio-economic development rather than financialisation of the economy.

Principles of Islamic Finance

Islamic finance emerged as a part of Islamic economic thought as part of its institutional aspect in 1970s. Islamic finance aims to fulfill the aspirations of IME through financing and regulating economic activity according to Islamic injunctions and ideals. IBF institutions aiming to articulate IME should serve social justice and social well-being as an integral part of their functioning in their attempt to function within the Islamic ethical values to achieve a balance between social and financial objectives. As socially constructed institutions IFIs, are expected to foster economic development where the main objectives are social welfare and social justice. While achieving prosperity is desirable in IME, the financial activities leading to it should be guided by the following Islamic principles:

(i) Prohibition of interest (or *riba*) is one of the core requirements that IFIs should observe.

(ii) ***Risk sharing***: Taking into account that *riba* is rejected and acquiring debt without having the means and intention to repay is discouraged in Islam. Islamic finance as a result prioritises joint ventures in various forms by emphasising risk-sharing aspect.

(iii) ***Asset-based***: The two aforementioned principles of Islamic finance propose the existence of a direct relationship among the real and financial sectors. Islamic law requires that each financial transaction should be tied to tangible underlying asset. Thus, financial and economic activities of IFIs are undoubtedly and directly identified with the real economic sector activity (Askari *et al.*, 2010: 13). As a result, IFIs have the objective of creating productive economic activities, which will lead to asset-based financing over the debt-based financing (Asutay, 2010b: 25).

(iv) ***The concept of money:*** According to Islamic thought, "money does not have any intrinsic value of its own apart from the value of the precious metals that are to be found in real sector production of the currency" (Choudhury, 2011: 293). Thus, IFIs are not allowed to engage in money creation out of debt. Central to IME is the idea that money serves to assist social and economic activities of individuals through being a measure of exchange (Ayub, 2007: 437). Generating money from money is harshly prohibited; for this reason, wealth can be created just by lawful trading and investing in assets.

(v) ***Prohibition of speculation (maysir) and uncertainty (gharar):*** Commercial activities in Islam are subject to the restrictions such as ban on *gharar* and *maysir*, where the former means uncertainty and the latter gambling or speculation. The prohibition of speculation, gambling and uncertainty emerges from the same rationale to highlight the importance of assed-based productive economic acitivity (Asutay, 2010b: 26).

(vi) ***Screening of investment activities to ensure whether they are Islamically permissible or not.*** Islamic financial framework based on strong moral values discourages entrepreneurs to invest in the production of goods and services and in any financial contract that contradict the IME principles. Thus, it excludes financing and investing in unethical industries such as casinos, pornography, tobacco, alcohol, drugs, harmful substances, nuclear energy or any sector, which activities are considered harmful and morally unacceptable to the interests of society and environment. Accordingly, investing in business activities that will cause the pollution or exploitation of common natural resources of environment, which include water, air, soil, minerals, plants, animals and energy resources is unlawful. Investors should seek to align their financial investments with Islamic financial principles in order to include social dimension to their activities and contribute to ethical and socially responsible projects.

(vii) Irfaq which is defined in the glossary of Islamic economics and finance as "Concessions in public property such as market places or inaccessible mines given to individuals on payment of certain duties or taxes" (Khan, 2003: 105). Thus, *waqf*, *zakah* and concepts of *sadaqah*, and *qard hasan,* which are the articulation of *irfaq* (Asutay, 2010a: 5), present additional explanation of accepting CSR, a part of Islamic framework paradigm, as an exogenous concept, which is expected to be apparent in IFIs:

Contemporary Islamic Models of CSR

This section aims at presenting the contemporary Islamic models of CSR by founding on the above discussion on IME and its articulations.

Chapra's Model

The early writings by Islamic economics fathers such as Chapra (1985) and Siddiqi (1983) suggest that the social role of all sorts of IFIs should be placed upon their objective of profit maximisation in order to maintain socio-economic justice, support and sustain economic development (Dusuki, 2007: 31; Sairally, 2006: 63). This view has been introduced in the more recent literature as Chapra's model (Sairally, 2006: 63 taken from Lewis and Algaoud, 2001: 95).

Taking into account that Islamic banks and other IFIs deal with public funds, they are required to consider the betterment of the whole society upon the benefit of individuals. This basically means that IBFIs have to fulfil social obligation as a religious compliancy as well as to perform other prearranged conventional financial tasks. This model envisages Islamic banks as multipurpose or universal banks that integrate commercial and merchant banking and provide wide range of financial services (Sairally, 2006: 63; Hassan and Lewis, 2007: 9). This view has been widely supported by academicians as Sadr (1982), Siddiqi, M. N. (1983, 1985), Ahmad, Z. (1984), Ahmad, K. (2000), Siddiqui, S. H. (2001), Haron (1995), Rosly and Bakar (2003), Haron and Hisham (2003), Naqvi (2003) and some others, who believe that for IFIs, setting objectives to promote Islamic religious principles, traditions and norms alongside the protection of the necessities of Muslim societies is as important as maximising their profit (Dusuki, 2008b: 135). Accordingly, it can be said that this model is compatible with the social and ethical goals of *Shari'ah* and Islamic spiritual objectives. Hence, "Islamic banks must promote social welfare programmes and activities and make more contributions towards the needy and the poor without undermining its commercial viability" (Dusuki, 2008b: 135).

According to this model, hence, there is a great expectation placed upon Islamic banks to be CSR-active and contribute significantly to social and economic problems of the less advantaged citizens in the society and at the same time Islamic banks should be able to maintain their commercial viability (Dusuki, 2008b: 135).

Ismail's Model

An alternative view was proposed by Ismail (1986), who argued that since IFIs are part of the commercial sector of the economy, they should be responsible only for economic and financial activities. All morally and socially concerned commercial activities are expected to be assigned to the third non-profitable sector.

In this model, Ismail draws an Islamic economic system, which consists of three financial sectors: the government sector or *siyasi,* the commercial sector or *tijari*, and the welfare sector also known as third sector or *ijtimai* (Hassan and Lewis, 2007: 10). Ismail (1986), thus, claims that Islamic commercial institutions of the commercial or *tijari* sector are restricted to be responsible to the shareholders and depositors and not to the society as a whole. Therefore, within this framework, social welfare objectives are not the primary tasks of Islamic banks and expected to be fulfilled by another institutions. In short, Ismail's view propagates the idea that Islamic banks are not different from other commercial financial institutions with the highest priority to conduct their affairs in a *Shari'ah* compliant way (Dusuki, 2008: 136 taken from Lewis and Algaud, 2001; Satkunasegaran, 2003).

Ismail's model has been further supported by Tag el-Din (2003) who articulated the position that socio-economic needs of the society should be left to the 'social sector' such as *waqf* and other charitable institutions. It is important, however, to state that socio-economic process cannot be done without including moral and ethical values (Sairally, 2006: 66).

Dusuki's Model (*Taqwa* Paradigm)

Taqwa paradigm, which inspires to consider CSR as part of religious obligations, was introduced by Dusuki (2008a: 15). *Taqwa* or God-consciousness can be characterised as "the individual, spiritual, moral, ethical, and psychological capacity to raise oneself to that higher level that makes a person almost immune from the excessive material desires of the world, elevating the individual to a higher level of prophetic self-consciousness" (Mowlana, 2008: 136). Thus, it is assumed that people with *taqwa* paradigm continuously seek God's pleasure and as a result, act in the line with the *Shari'ah* principles. Harmonising, integrating and combining worldly affairs with spiritual values are essential for individuals, as this will determine the fate in this world and the hereafter. Individuals and corporations that embrace *taqwa* paradigm undertake their responsibilities as vicegerents of God in all circumstances, which make them accountable to God, who is the owner of themselves and the resources they utilise and manage (Dusuki, 2008a: 15; Dusuki and Abdullah, 2007: 9). The role of *khalifa* provides human beings with the authority over the creation and this authority is accountable.

According to Dusuki (2007b: 34), corporations that operate in compliance with the *Shari'ah* principles and employ *taqwa*-paradigm in their approach of conducting business activities do not focus solely on profit generation as they acknowledge and put more emphasis on the importance of social, ethical and moral dimensions in their agenda.

Four major points have been promoted by Dusuki's *taqwa* paradigm: human dignity, free will, equality and rights, trust as well as responsibility (2005: 47-49). He further argues that CSR from Islamic perspective takes more holistic approach, which distinguishes it from the Western approach (Dusuki, 2008a: 13). The idea central to this view is that achieving success and happiness in this world is as crucial as accomplishing *falah* and happiness in the hereafter. Dusuki (2008a) highlights that CSR has a broader meaning from Islamic hallmark as it values more on spiritual reward rather than material reward.

Reflecting on the Models

There are similarities that can be drawn between Chapra's model and Carroll's (1979) view of CSR as well as between Ismail's (1986) model and Friedman's vision of CSR. The two main aforementioned models of CSR attributed to IFIs by modern Islamic economists can also be associated with the UK and USA models of CSR (Dusuki, 2008b: 136-137; Hassan and Lewis, 2007: 10-11; Sairally, 2006: 66-67). In Chapra's model, Islamic banks regarded as universal institutions, where the provision of social services emphasised beside the objective of profit maximisation. Furthermore, social welfare projects of IBFIs should be in line with the principles of *Shari'ah* with the focus placed on the maximisation of stakeholders' interests. Moreover, the ethical and social responsibility inherently imposed on business and economic activities, as religious compliancy would imply that philanthropic activities would be integrated into the business concept of IFIs due to their expected role towards community development. Consequently, Chapra's model can be related to the Carroll's (1979) vision of CSR, which encompasses four main agenda: responsible business practices, consumer responsibility, sustainable enterprise and corporate philanthropy.

Additionally, the parallels can been found between Chapra's view and the UK approach to CSR, where social issues are tackled explicitly by institutional networks. In this situation, "the business policy on social responsibility … is taken as part of the wealth creation process and to increase the competitiveness of the business and the value to the society (Baker, 2004) - with the motivation for acting in a socially responsible way within the Islamic paradigm being faith driven" (Sairally, 2006: 66-67).

On the contrary, Ismail's (1986) model has similarities with the new-classical point of view, famously advocated by Friedman (1970) who "defined the social responsibility in a strictly limited neo-classical economic sense", where corporations are only responsible to their stakeholders due to their considerable contribution towards capital maximisation (Bichta, 2003: 16). Ismail's view analogously accepts IFIs as commercial institutions functioning within Islamic framework and fulfilling mainly the interests of their shareholders and depositors. As IFIs are expected to be developed into profitable and sustainable institutions, social goals in this model are pursued indirectly. This model can also be associated with the implicit approach of CSR in America, where the social issues addressed implicitly by corporations through their CSR policies, programs and strategies (Matten and Moon, 2005: 336). Thus, CSR in this situation does not take place at the top of the management agenda and not an integral part of a company's strategy. As a result, in Ismail's model CSR initiatives should be undertaken by the third non-profitable sector.

Dusuki (2008b: 137) extends this discussion by stating that Chapra's and Ismail's models do not actually have significant differences, except in degree and emphasis. The application of Ismail's model of CSR would be more appropriate to Islamic banks operating in multi-religious countries with different traditional religious communities. On the other hand, applying Chapra's model to Islamic banks might be more successful in the countries with dominant Muslim population (Dusuki, 2008b: 137 taken from Satkunasegaran, 2003).

Islamic CSR and the Practices of Islamic Banks and Financial Institutions

Islamic finance as an operational tool of IME is dedicated to maintain the economic and social development with the objectives of essentialising human centred economic development and improving human well-being, within the social economy of Islam (Asutay, 2007b: 11). Despite the impressive growth of Islamic finance in the last three decades, and its spiritual underpinnings, it appears that the sector is still searching for its soul (Chowdhry, 2006). While Islamic finance is considered as an ethical alternative to conventional finance, however, there are concerns over its Islamicity and hence the ethicality of IBF. Islamic finance, thus, has been criticised for being materialistic and loosing the spirit of IME. This issue has been discussed extensively in the modern literature of Islamic finance (Asutay, 2007b; Kuran, 1997; El-Gamal, 2000; Warde, 2000; Obaidullah, 2008; Abozaid and Dusuki, 2007; Sairally, 2005; Halim, 2000; Siddiqi, 2004).

As has been highlighted by numerous scholars, the gap between the ideals and realities of Islamic finance is growing. Until recently, researchers mainly focused on the form rather than on the substance of Islamic finance. In fact, Islamic finance has neglected the morally based value judgment, constituting the substance as opposed to the rules, and norms of IME or the forms (Asutay, 2009: 3). As a result, Islamic finance has been criticised for converging towards conventional products.

Although by mimicking the conventional debt-based instruments and products the legal mechanism of Islamic financial transactions complies with the *Shari'ah* principles, it shuns the spiritual underpinnings of Islamic law. Therefore, the current debate is developing around Islamic based finance (fulfilling all the social requirements) versus the *Shari'ah* compliant finance, as practiced in current times. This view has been supported by El-Gamal (2006: xi), who describes the current practices of Islamic finance as "Islamization of contemporary financial practice … accomplished by means of modified premodern financial contracts (such as sales, leases, and simple partnerships)".

Critics claim that the nature of IFIs do not distinct from the nature of their conventional counterparts as they apply modified conventional practices. According to Siddiqi (2007) and Chapra (2010), IFIs have been struggling in achieving the *Shari'ah* authenticity of Islamic financial products, hence, have too many similar characteristics with conventional finance. Consequently, "Islamic finance has arguably failed to serve the objectives of Islamic law (maqasid al-Shari' a)" (El-Gamal, 2006: xii) since the distinguishing factor of Islamic finance from conventional finance is its underlying philosophy, not *only* the prohibition of *riba* or the features of contracts.

Therefore, it is essential for Islamic finance to preserve the values of IME, which promotes "profit-and-loss sharing, and hence risk-sharing; thus partnership against the dominance of the strong, namely the capital; serving humanity and society for the sake of spiritual attainment and to perceive resources as trust from God, and hence directing all the resources to their perfection; spiritual accountability; and working for social good and justice not as a voluntary exercise but also in some cases as compulsory acts" (Asutay, 2010c) in order to have ethical IFIs.

Taking into account these values of IME, which are, unfortunately, have been neglected in the current Islamic finance practices, Islamic banks are imposed to add ethical and CSR financing issues in their agenda alongside the other banking practices (Ahmed, 2004: 131). IME emphasises the importance of a social welfare system based on mutual help as the development of societies is impossible without maintaining the social justice, where the most impoverished and marginalised are reached, their basic needs are met and resources are distributed equally; thereby, Islamic finance is capable of playing a key role in building communities. However, in the reality the situation is not that optimistic as the statistics show that the large share of Muslim population in the world is still financially excluded because the delivery of basic financial services to the people from disadvantaged strata does not exist or still at the very beginning (Mohieldin *et. al.*, 2011: 2).

Furthermore, several studies reveal that the concept of CSR in IFIs is still in its infancy and their understanding of being socially responsible is limited to *zakah* distribution (Sairally, 2005). Despite having the social objective as an inherent function, critics argue that IFIs are mainly focused on commercial and economic aspects of the industry. Therefore, as Asutay (2010b: 25-26) stresses, there is an urgent need to unlock the potential of IFIs and its social significance through the mechanism of microfinance and social banks. Based on Islamic principles of social equity and redistributive justice, microfinance within Islamic finance framework can be recommended to be provided by the following instruments and institutions of IBF (Asutay, 2010b: 26).

Against this background, however, microfinance has not been well developed enough in the agenda of IFIs (Obaidullah, 2008: 3). The good examples of Islamic microfinance (IMF) can be found in Syria and Yemen, where IMF institutions where sanctioned by the government, in Indonesia and also in Bangladesh with the substantial help of Bangladeshi Islamic Bank (Asutay, 2010b: 27). However, these attempts are not enough and there is a huge dissatisfaction with the performance of the Islamic finance industry. While the large amounts of resources and efforts have been channelled to develop the Islamic finance sector, the same should be done in order to further the development of Islamic microfinancing.

Socio-economic status of communities cannot be improved through allowing the use of increasingly sophisticated financial instruments that currently prevailing in the market and have solely economic purpose. The industry of IBF, unfortunately, largely implements the form of debt-like instruments that mirror images of conventional debt financing instruments and have alike economic and social effects. As a result, the exciting inconsistency between the aspirations of IME and realities of Islamic finance has occurred and is shifting towards the directions of neoclassical economics. This situation has been defined by Asutay (2010b) as the 'social failure of Islamic finance'. In line with Asutay's (2010b) argument, the study conducted by Hassan and Harahap (2010), which includes seven IFIs, shows that Islamic banks do not have sizable CSR initiatives (Aribi and Gao, 2012: 206). Another research of thirty-two Islamic banks conducted by the scholars from the International Institute of Islamic Thoughts (1996) has been able to demonstrate the overriding emphasis on economic goals and not the social goals of the banks under the study. This study also reveals that in assessing attractiveness of the investment, economic conditions have greater impacts than social (Maali *et al.*, 2006: 269).

Thus, in order to overcome the apparent divergence between initial objectives and realities of Islamic finance, the virtues of IME should be unlocked further. The substance of the products should be reviewed with the same seriousness as the compliance of contracts' forms to *Shari'ah*. Islamic finance "must break free of the temptation to take the path of replicating conventional products. Success on the material plane by sacrificing its spiritual mandate is an actual failure from an Islamic perspective" (ISFIRE, 2012: 22).

Despite their social failure and several limitations, Islamic banks play a significant role in terms of pooling funds and they have demonstrated to deliver desired valuable services that balance the needs of consumers and producers. Therefore, in order to enhance the social potential of Islamic banks and correct the observed failure of Islamic finance "robust social justice oriented principles" should be introduced "into IBF by endogenising social justice into its operational nature" (Asutay, 2010a). Consequently, the attention should be drawn from the legal frame of the Islamic contracts to the spiritual message of the IME, which could help to reduce the gaps between the realities of Islamic banking and the aspirations of IME. This reorientation should reinforce the universality and acceptability of Islamic finance, hence, would allow it to become a distinctive value proposition.

Conclusion

In summary, this paper provides the Islamic perspectives on CSR and justice as an alternative to the Western theoretical constructs of CSR. It presents the socially responsible vision and objectives of IME with the recourse to the objectives of the Islamic law and an integration of moral filter to the practices of IBF. It highlights the reasons of CSR becoming an integral part of IME and hence, IBF through underlining Islamic financial principles alongside philosophical foundations of Islamic economic system. Thus, based on the discussion and considering the definition of CSR, IBF by definition should be CSR compliant. However, the realities of IBF deviate from the ideals of IME and Islamic finance has become a part of the international financial system with the ambitions.

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Fixed Income Investment (*Sukuk*) in Islamic Finance

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Abstract

Recently many books, newspaper articles and research papers have been written under the heading of "Sukuk". In this article we will try to provide a brief explanation of the meaning of Sukuk and its presence in the global financial markets.
New Sukuk issuance worldwide could once more exceed $100 billion this year (2013), according to S&P (March 2013) due to support from tight yields and innovative structures. Funding needs and large infrastructure investments in the Organization of Islamic Cooperation countries (OIC), combined with better global investor sentiment, lie behind today's momentum in the Sukuk market.
The Gulf Cooperation Council countries (GCC) and Asia will remain the key engines for growth of the Sukuk market.
Growth in cross-border Islamic bond issues points to greater convergence in an industry that has been divided by tensions between the Middle East and Asia regarding Sukuk rules, opening the door to a much wider pool of investors. However, structures are still not standardised, and some Gulf-based Shariah scholars have objected to certain structures used in Asia, a region that has proven to be more flexible in its transactions.

Keywords: *Riba, Sukuk, SPE, OIC, IIFM, MENA, MYR.*

Introduction

The high-profile growth and prevalence of Sukuk in the Islamic finance industry over recent years has rendered the term, "Sukuk" synonymous with Islamic capital markets. This Shariah-compliant alternative to interest-bearing investment certificates or fixed-income securities has led

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to the product being commonly referred to as an "Islamic bond" in recognition of its ability to offer Islamic investors a means of subscribing to certificates which represent a right to receive a share of profits generated by an underlying asset base and that is capable of being traded on the secondary market.

Debt instruments such as coupon or zero-coupon bonds in conventional capital markets cannot be used in Islamic Finance due to the element of riba (interest) present. However, fixed-income type instruments are sought by investors seeking exposure to different risk factors or asset classes as part of their efforts to diversify their investment portfolio. Fixed-income type instruments that provide a steady stream of regular cash flows in the future are advantageous for liability management.

This has made Sukuk an attractive product to sovereign and corporate issuers alike who have used Sukuk to access a wider range of financing sources for their increasingly sophisticated financing and investment purposes.

There is anecdotal evidence[1] to suggest that Sukuk structures were used within Muslim societies as early as the Middle Ages, where papers representing financial obligations originating from trade and other commercial activities were issued.

What is Sukuk?

The word, "Sukuk", can also be traced back to classical commercial Islamic literature. It was used in reference to certificates for goods or groceries ("sakk al-bada'i") as the method of paying the salaries of government officers, who would later redeem these certificates in line with their day-to-day consumption of such goods or groceries. However, the Sukuk, as understood in its contemporary form, lies in a decision of the Islamic Jurisprudence Council (the "IJC") dated 6-11 February 1988[2] which stated that, "any combination of assets (or the usufruct of such assets) can be represented in the form of written financial instruments which can be sold at a market price provided that the composition of the group of assets represented by the Sukuk consist of a majority of tangible assets."

Global Sukuk Market

There were early attempts to issue Islamic bonds (Muqaradah bonds related to project financing) in the late 1970s in Egypt and Jordan. Pakistan and Malaysia also attempted to develop a market for such bonds. However, development did not really pick up until the growth of securitization in the conventional capital markets suggested a way ahead for the Islamic markets. In the late 1990s, asset-backed bonds (securities) known as Sukuk were developed in Bahrain and Malaysia. The Sukuk framework avoids interest payment through the use of classical Islamic contracts, such as ijara (leasing) contracts. The availability of long-term funding at competitive rates for investments and infra-structure development is crucial to an economy. For Sukuk markets to thrive, it is imperative that Sukuk meet the needs of companies and governments who raise capital and the investors who possess capital. Issuers (companies and governments) seek competitive cost of funding as well as liquidity of funding for the maturity that they need. Investors, on the other hand, seek attractive risk-return profiles for their investments and exposure to wider classes of assets for diversification purposes.

In a similar manner to a securitization, a Sukuk certificate is issued against a pool of assets. Sukuk certificates represent ownership in the assets. Cash flows from the assets will be used to pay investors of Sukuk certificates. The performance, as well as risks, of Sukuk is tied to the asset pool. The assets are linked to underlying physical objects and are permissible. For example, the assets may be ijara (leasing) contracts or salam contracts which have physical assets as underlying factors. These contracts are related to the funding or purchase of permissible assets. The assets need not be in existence at the time of securitization. For example, the Sukuk issuance may be used to fund the development of an infrastructure project such as a bridge or a factory. Depending on the types of assets and financing contracts, different forms of Sukuk may be issued. Some examples include Sukuk al-Ijarah, Sukuk al-Musharaka, Sukuk al-Mudaraba, Sukuk al-Salam, Sukuk al-Istisna, Sukuk al-Murabaha, Sukuk al-Istithmar andSukuk al-Wakala. In a manner similar to securitization in conventional finance, a Sukuk issue may involve a Special Purpose Entity (SPE).

Sukuk and other structured finance transactions have often utilized SPEs established in offshore jurisdictions. These have been partly established for tax purposes, but also due to uncertainties in the legal framework and enforcement process in the courts in relation to structured finance in the Organization of Islamic Cooperation countries (OIC).

The income stream from the asset is used to pay the management fees and the investors. The role of the trustees is to safeguard the interest of the investors and to make sure that the assets are managed in a responsible manner and in compliance with the terms and regulations in the prospectus. At the end of the investment period, the assets may be sold at a predetermined price to the original owner and the proceeds from this sale will be used to pay the principal sum on the Sukuk.

Investor appetite is pushing Sukuk into the mainstream. New Sukuk issuance worldwide may exceed $100 billion again this year, according to S&P (March 2013) supported by tight yields and innovative structures[3].

Funding needs for large infrastructure investments in Malaysia and the GCC, combined with better global investor sentiment, are behind today's momentum in the Sukuk market.

Global Sukuk issuance increased 64% in 2012, to USD138 billion – the fourth consecutive year of growth. It is widely accepted that sovereign and sovereign-related issuance, arising from funding and infrastructure investment needs, will continue to dominate, shape, and underpin the market. Government-linked companies/entities' issuance reached a record $115 billion globally in 2012, comprising about 80% of total issuance for the fourth year in a row.

Profits paid by Sukuk issuers globally have been declining, and even fell below those based on conventional debt models. We should also consider in this context the strong domestic appetite for Islamic finance and ample liquidity as well as the greater political willingness to move ahead with sizable infrastructure projects. The demand for Islamic fixed income products such as Sukuk is on an upward trajectory for the foreseeable future.

It is expected that a number of banks will come onto the market, needing to refinance their existing debt and seeking larger amounts of capital to match the credit needs of their corporate clients, especially in project finance.

The Malaysian Ringgit (MYR) is becoming the currency of choice. For the first time last year, the amount issued in ringgit worldwide exceeded the amount provided by Malaysian issuers in all currencies. The strength of the Malaysian model for Islamic finance is an alluring proposition for issuers and investors alike, especially in the OIC, further strengthening Asia as a primary force in this sector.

Positive growth in Sukuk has been attributed to the rapid geographical expansion of products and services in Islamic securities that have enjoyed remarkable growth in key markets across Europe, Asia Pacific, Middle East and Africa (MENA)and the Central Asian states.

Growth in cross-border Islamic bond issues points to greater convergence in an industry that has been divided by tensions between the Middle East and Asia over Sukuk rules, thus opening the door to a much wider pool of investors. Hence, the Asian and OIC Sukuk markets are becoming more interdependent, notably those denominated in Malaysian ringgit.

The past year, however, has seen a number of cross-regional Sukuk, mostly by Gulf issuers accessing Malaysia's highly liquid market, the world's largest for Sukuk issuance. Malaysia's sovereign wealth fund has also launched a Sukuk product denominated in Chinese Yuan.

The development of Shariah-compliant hedging tools is making it easier for issuers to invest in foreign currency assets. The launch of the Tahawwut (Hedging) Master Agreement (TMA) in March 2010 by the Bahrain-based International Islamic Financial Market (IIFM) in cooperation with the International Swaps and Derivatives Association, Inc. (ISDA) equips the global Islamic financial industry with the ability to trade Shariah-compliant hedging transactions such as profit-rate and currency swaps, which are estimated to represent most of today's Islamic hedging transactions. As such, it is premature to suggest that the Tahawwut Master Agreement "is applicable across all jurisdictions where Islamic finance is practiced" because it would clearly be subject to the vagaries of the legal and political governance process across various jurisdictions.

Voluntary adoption of standards in the financial sector by Muslims countries is very underdeveloped and, very often, national practice takes precedence over the less well-established international organizations especially in the nascent Islamic finance space. In addition, in markets such as Malaysia, they have developed local Shariah-compliant hedging techniques including profit-rate and currency swaps quite some time ago[4].

The Attraction to Turkey

The Turkish Sukuk Market is expected to become even more attractive starting in 2013 and moving into 2014 due to the elevation of Turkey's credit rating and the willingness of government and financial authorities to transform Turkey into one of the main Islamic Financial Hubs. The Turkish Undersecretariat of the Treasury in conjunction with the Capital Markets Board of Turkey is finalizing new regulations, which would widen the type of Sukuk structures that can be used. At present, only Sukuk Al-Ijarah originations are used, in addition to Sukuk Al-Murabaha[5].

Conclusion

To conclude, despite the unfavorable market conditions throughout 2012 to 2013, the emergence of numerous new major issuances emanating from the UAE, Malaysia, Saudi Arabia, Turkey, Qatar and Indonesia mean that it will most likely prove to be an extremely interesting year in the field of international Sukuk.

Growth in cross-border Islamic bond issues points to greater convergence in an industry that has been divided by tensions between the Middle East and Asia over Sukuk rules, opening the door to a much wider pool of investors. However, structures are still not standardized, and some Gulf-based Shariah scholars have objected to certain structures used in Asia, a region which has proven to be more flexible in its transactions.

Glossary

Ijarah: Letting on lease. Sale of defined usufruct of any asset for a defined period in exchange for a specific rent; only those assets can be leased the corpus of which is not consumed with use or the form/shape of which is not entirely changed with use. For example, cotton, yarn, fuel, milk, money can be sold/bought, but not leased against rentals. This is because the lessor has to bear the risk related to the ownership of the asset, and this is possible only if the leased asset remains intact and the lessor gets reward in the form of rental against taking risk.

Istisna'a: Order to manufacture (for purchase). It is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or future payment and future delivery. Istisna'a can be used to provide facilities for financing the manufacture/construction of houses, plant, projects, bridges, roads and highways.

Mudarabah: A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while any loss is borne by the provider of the capital.

Muqaradah: The term "muqaradah" has been taken from the fiqh concept with reference to its synonym "mudarabah" which is commonly used by the Hanafi and Hanbali schools of thought. An agreement between two parties by which one of the two parties provides capital for the other to work with on the condition that the profit is to be shared between them according to an agreed ratio.

Murabaha: Literally, this means a sale on mutually-agreed profit. Technically, it is a contract of sale in which the seller declares his cost and the profit. Islamic banks have adopted this method of sale as a mode of financing. As a financing technique, it can involve a request by the client to the bank to purchase a certain item for him. The bank executes this request for a definite profit over the cost.

Musharakah: Partnership between two parties, who both provide capital towards the financing of a project. Both parties share profits on a pre-agreed ratio, but losses are shared on the basis of equity participation. Both parties carry out management of the project. However, the partners also have a right to forego the right of management/work in favour of any specific partner or person. There are two main forms of Musharakah: 'Permanent' Musharakah and 'diminishing' Musharakah.

Riba: Literally, an excess or increase. Technically, it means an increase over the principal in a loan transaction, over a debt or in exchange transactions, accrued to the lender/creditor or a party to exchange without giving an equivalent counter value or recompense ('iwad) in return to the other party.

Salam: Salam ,in this context, means advance payment against deferred delivery of goods. Salam (also referred to as Bai Salam, Al-Salam, Bai al-Salam) is an ancient form of forward contract wherein the price is paid in advance at the time of making a contract of sale for goods to be delivered at a future date.

Sukuk: Certificates of equal value representing undivided share in ownership of tangible assets of particular projects or specific investment activity, usufruct and services.

Sukuk al-Istithmar: An Arabic term for investment Sukuk. These are certificates (Sukuk) of equal value which are issued and sold to investors (as owners or bearers) who, by virtue thereof, have proportional claims over the financial rights underlying these certificates. Likewise, investment Sukuk holders will also be proportionately liable for obligations arising from these certificates. In this sense, investment- related Sukuk represent common shares in the pool of assets made available for investment, of whatever type (physical assets, non-tangible assets, usufructs, services, receivables, or any combination of these types).

However, these Sukuk are not bonds or fixed-income securities, as they do not represent debts owed to the issuer by Sukuk holders. Holders share Sukuk returns and proceeds according to percentages stated in the prospectus, and bear losses in proportion to the number of certificates (Sukuk) held by them.

Tahawwut: A master hedging agreement developed by IIFM and ISDA.

Wakalah: Contract of agency; this can be commutative or noncommutative.

Endnotes

1 Source: Standard & Poor's "Investor Appetite is Pushing Sukuk into the Mainstream (March 2013)
2 Dubai Financial Centre Sukuk Guidebook
3 Bloomberg, KFH Research and Standard & Poor's "Investor Appetite is Pushing Sukuk into the Mainstream (March 2013)
4 www.financialislam.com
5 www.spk.gov.tr

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Islamic Liquidity Management: The Way Forward

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Abstract

Even though very small compared with conventional finance, there has been significant growth in Islamic financial services during recent years. It is not surprising that this growth is forecast to continue at a rapid pace. Clearly, there is an expanding demand for these products, and a closely associated desire on the part of banks, including non-Islamic banks, to provide Islamic financial services. As the interest in the subject of Islamic finance increases, there appears the need for innovative and competitive Islamic products which are Sharia-compliant. On the other hand, the development of Islamic finance faces challenging issues. Liquidity management of Islamic financial institutions has been one of the most challenging and discussed issues with regard to the trend outlines above. Especially the short term-liquidity management issue is very problematic for these institutions since it is very hard to find globally accepted, Sharia-compliant, liquid short term instruments that may be used in liquidity management. Recently, there have been attempts to provide these kind of instruments with no (little?) success being recorded as of date. The Islamic financial industry waits in eager anticipation for a solution to the problem that may present a way out of the current empasse.

Keywords: *Islamic finance, islamic liquidity management, IILM*

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Introduction

The Islamic financial system can be defined as a set of financial institutions and instruments (?) used by clients and institutions which provide opportunity for Sharia-compliant economic activities. Islamic Financial Institutions (IFIs) have become popular due to demand for specific financial services and as a result of the accumulation of substantial financial resources by certain Muslim countries. In the medium term, current trends of IFIs' development will be stable, considering that oil-exporting countries continue to receive substantial income and the financial markets of these countries are expected to continue to evolve.

On the other hand, during recent years traditional banks have displayed a great interest in entering the market of Islamic financial products. Thus the majority of multinational banks already have "Islamic windows". This is due to the increase of Muslim populations in developed countries as well as the growth of interest of Islamic investors in the geographic diversification of their investment portfolios. Additionally, as a consequence of global financial liberalization the extent of penetration of IFIs in the US and Western Europe appears to suggest that sooner or later they will potentially become a feature of all countries' financial systems. However, the full operation of IFIs will not be possible without the strengthening of liquidity management and changes in related legislation.

There have been many issues discussed with respect to Islamic finance and banking. In this sense liquidity management has been one of the most-discussed and challenging issues with respect to the above. The main reasons behind this issue coming to prominence are concerns regarding the degree to which liquidity is Sharia-compliant, the lack of properly structured and easily transferable instruments, the necessity for IFIs to maintain higher cash reserves when compared to their conventional counterpoints and their holding of a zero-return reserve in their portfolio which harms the profitability and competitiveness of the IFIs. Even though there exist successfully applied local products and instruments which have been customized by the monetary and regulatory authorities to help IFIs overcome this hardship and facilitate their liquidity management, there remains a clear lack of globally-recognized and widely-accepted instruments.

Islamic money markets need to be integrated globally, not only regarding relations between the IFIs themselves, but also with conventional markets in an efficient, Sharia-complaint and simple way to facilitate liquidity management for IFIs and to ease the flow of funds between countries and different markets.

Islamic Liquidity Management

Liquidity management can simply be defined as the ability of a financial institution to remain 'liquid' enough to make its payments on time while maintaining an optimal cost-return balance to achieve that purpose by means of selecting and using the most appropriate tools for this aim. Meeting demand for deposit withdrawals and other cash outflows is a visible indicator of its viability. While goals and objectives can differ depending upon the circumstances and environment of the financial institution, a prudent liquidity management should always address ensuring enough liquidity to guarantee the orderly funding of the depositor's needs, providing a prudent cushion for unforeseen liquidity needs and investing liquid funds in a manner which emphasizes the need for security and liquidity. On the other hand, Islamic liquidity management does not differ from conventional liquidity management in terms of purpose and reasoning but with regard to the need to use different tools because of Sharia-compliance concerns. Islamic and conventional banking systems are similar as they are both based on fractional reserve systems and a depositor run on banking system constitutes the greatest risk and challenge to the liquidity management and financial system. But on the other hand development of a new Islamic financial instrument and a new structure to base the instrument on, as well as Sharia concerns, regulatory and tax treatments and leakages of funds in a dual-banking system expose additional risks in terms of developed Islamic liquidity management.

Current Practices

The Task Force on (for?) the Islamic Money Market, established by IFSB in 2008 and whose members consist of central bankers, bankers and regulators, released a technical note regarding the existing practices and infrastructure of the Islamic Money Markets and arrived at some recommendations for more efficient liquidity management. According to this report, in the countries which provided data, IFIs hold two to ten times more excess reserves at central banks as a percentage of their deposits compared to conventional ones so as to be able to remain sufficiently liquid. In other words, cash is the most used tool by its nature to remain liquid, but this comes at a cost to IFIs. This does not render cash as the optimal choice for IFIs, even though it constitutes the least risky choice, because it deprives the IFIs of a certain yield and flexibility provided by the tools which are used by their conventional peers.

The most common interbank tool which is used to facilitate fund transfer between a cash-surplus IFI and a deficit IFI with a specific amount of yield is the *commodity- murabahah* agreement. An underlying commodity is purchased by the cash-surplus bank and sold to the deficit bank on a deferred basis via an exchange platform such as the London Metal Exchange, Bursa Malaysia or with the assistance of some private companies which provide these kinds of platforms. This arrangement is widely used in all jurisdictions, but not in tradable transactions, even though this is standardised under Sharia Rules. Moreover there is a certain degree of market risk and this may not prove enough for monetary operations. Sukuk (Islamic bonds?) trading is another way of managing liquidity among the IFIs, but it is very rare due to underdeveloped secondary market trading, a tendency to 'buy and hold' and limited issuance of globally recognized tradable sukuk. There are other Islamic contracts such as *wakalah* to manage liquidity and facilitate funds transfer and, of course, spot FX markets are widely used to facilitate liquidity management.

Central Banks or Monetary Authorities of different jurisdictions develop and use different instruments to facilitate liquidity management for IFIs. As is well known, central banks have lending and borrowing facilities for the banks under their purview and can do outright sell and buy of a defined group of instruments for monetary policy purposes if it requires. In order for a bank to borrow from a central bank, it first needs to have a certain amount of collateral. For IFIs there need to exist Islamic securities. Central Bank of Malaysia has the first and only Islamic Interbank Market in the world which represents a real breakthrough in the attempts to facilitate Islamic liquidity management. There are several instruments used in this market which help Islamic financial institutions acquire sound liquidity management within the dual banking system of Malaysia. One of the most widely-used ones is *Mudharabah* Interbank Investment which refers to a mechanism whereby a deficit Islamic banking institution (i.e. an investee bank) can obtain investment from a surplus Islamic banking institution (investor bank) based on Mudharabah (profit sharing). The period of investment ranges from a period of overnight to

12 months, while the rate of return is based on the rate of gross profit before distribution for investment of 1-year of the investee bank. Another instrument is wadiah acceptance which represents a transaction between the BNM and the Islamic banking institutions and refers to a mechanism whereby the Islamic banking institutions place their surplus funds with the BNM based on the concept of *Al- Wadiah*. Under this concept, the acceptor of funds is viewed as the custodian for the funds and there is no obligation on the part of the custodian to pay any return on the account. Moreover when the first Islamic bank in Malaysia began operations in 1983, the bank was unable, among other things, to purchase or trade in Malaysian Government Securities (MGS), Malaysian Treasury Bills (MTB) or other interest-bearing instruments. However, there was a serious need for the Islamic bank to hold such liquid papers to meet the statutory liquidity requirements as well as to place its 'idle fund'. To satisfy both requirements, the Malaysian Parliament passed the Government Investment Act in 1983 to enable the Government of Malaysia to issue non-interest bearing certificates known as Government Investment Certificates (GIC) which have now been replaced with Government Investment Issues (GII). One other important Islamic instrument on the Islamic interbank market are the Bank Negara Malaysia Ijarah Sukuk based on the Al-Ijarah or 'sale and lease back' concept, a structure that is widely used in the Middle East, too. A special-purpose vehicle, the BNM Sukuk Berhad as an SPV has been established to issue the sukuk Ijarah. The proceeds from the issuance are used to purchase Bank Negara Malaysia's assets. The assets are then leased to Bank Negara Malaysia for rental payment consideration, which is distributed to investors as a return on a semi-annual basis. Upon maturity of the sukuk, Ijarah SPV then sell the assets back to Bank Negara Malaysia at a predetermined price. On the other hand, the BNM has recently adopted the Collateralized Commodity Murabahah (CMM) which is also widely used and accepted as Shariah-compliant in GCC countries. This instrument can basically be seen as a form of commodity murabahah but CMM requires a borrowing party to present certain eligible collaterals to the lender as a rahn.

On the other hand, GCC Countries have established themselves as important players in the Islamic financial services industry. The GCC Central Banks issue Certificates of Deposits (CDs) for IFIs and this instrument is accepted as collateral by the central banks for Collateralized Commodity Murabahah (CMM) agreements which are used for the purpose of repo-like lending by the central bank concerned.. As a third alternative, and to cite another example other than Malaysia and the GCC states, in Turkey, the Treasury issues Revenue-Indexed Bonds (RIB) for IFIs and these are used as underlying securities in a SBBA agreement with the Central Bank of Turkey. However, due to concerns related to the degree of their Sharia compliance, RIBs have become a questionable investment tool and IFIs in Turkey. Last year in September 2012, the Turkish Treasury issued its first sovereign sukuk.

Regulatory initiatives

With respect to the regulatory environment, the Islamic Financial Services Board Task Force has stated important recommendations in order to provide for the establishment of a sound and efficient Islamic money market that could facilitate liquidity management by central banks and IFIs. According to these recommendations, the first important issue is to design Islamic money markets and Islamic government-financing instruments harbouring relatively low risk that are simply designed, regularly issued, widely held and accepted and supported by a robust payment and settlement system. The second issue is to incorporate Islamic government-finance instruments as an integral part of the overall public debt and financing programme, and foster the development of an Islamic government securities market. Thirdly, the active use of Islamic government finance instruments in market-based monetary operations of the central bank to manage the liquidity in the Islamic money market is another crucial issue. One other issue to be emphasized is the need to develop efficient trading arrangements and the associated market microstructure for Islamic money and government financial instruments, and develop foreign exchange markets in parallel. Lastly, the provision of supervisory guidance and incentives for effective liquidity risk and asset liability management by IFIs, and the fostering of privately issued Islamic money market securities hold great importance in successful liquidity management.

The Way Forward

Taking into consideration the recommendations proposed by the IFSB and the increasing need for short-term liquidity management in Islamic finance, several central banks, monetary authorities and multilateral organisations decided to create an international corporation to issue short-term Sharia-compliant financial instruments to facilitate effective cross-border Islamic liquidity management. They named this organisation the International Islamic Liquidity Management Corporation (IILM) By creating more liquid Islamic financial markets for institutions offering Islamic financial services (IIFS), the main goal of the IILM has been established, that of enhancing cross-border investment flows, international linkages and financial stability.

Established in 2010 and headquartered in Kuala Lumpur, the shareholders of the IILM are the central banks or monetary authorities of Indonesia, Kuwait, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Saudi Arabia, Turkey and the United Arab Emirates as well as the Islamic Development Bank. In 2012, Saudi Arabia vacated its membership and the share of Saudi Arabian Monetary Authority was divided between Qatar and Malaysia. As an international institution, IILM enjoys a range of privileges and immunities conferred by the Malaysian IILM Act of 2011. Membership of the IILM is open to central banks, monetary authorities, financial regulatory authorities or government ministries or agencies that have regulatory oversight of finance or trade and commerce, as well as to multilateral organisations.

So on the journey forward, with respect to Islamic liquidity management the IILM can play important roles. First of all, the IILM is expected to create globally recognized and highly rated short-term money market instruments in reserve currencies and regularly issued 3,6,12 month tenors with a relatively low risk. An internationally recognized settlement and custodian bank such as Euroclear or Clearstream is expected to be used to ensure a robust and credible settlement provision and to satisfy the warehousing purposes of future sukuk. Secondly, the IILM is supposed to acquire sovereign assets from member countries and finance-member countries. The IILM will consequently become a part of long-term government issuances and play an important role as a financing platform for local borrowing authorities. Hence, the IILM can help governments to issue Islamic securities or sukuk. Moreover, the sukuk of the ILLM might be accepted and used efficiently by central banks in their monetary policy applications. For example, central banks might accept the sukuk of the IILM as eligible collateral. In addition, to widen the market base and in order for central banks to have a quality asset alternative in their portfolio, IILM sukuk can be invested and traded in as well as employed for foreign- reserve management purposes. It can also be used as reverse repo instrument in tandem with local Islamic securities for the purpose of sterilisation of ample liquidity in both the Islamic and conventional banking systems. IILM sukuk can foster the flow of global Islamic funds as a perfect trade instrument. Considering that Islamic finance is based on trade, IILM sukuk can be traded on secondary markets efficiently through a strongly established chain of primary dealers. Since it is expected that there will be at least one primary dealer from each member jurisdiction within this chain than this will create liquidity and increase the tradability of the sukuk on the secondary market. Hence, through the establishment of a liquid secondary market over time, the IILM sukuk can help facilitate the short-term flow of funds and replace, in particular, costly and operationally burdening short-term cross-border commodity murabahah arrangements. Additionally, as a perfect liquid instrument it can attract conventional money market players, and facilitate the flow of funds between conventional and Islamic markets. Being issued in reserve currencies like USD, IILM sukuk can represent a good alternative as a foreign currency market instrument at the same time. Furthermore, IILM sukuk can serve to help lessen the negative effects of interconnectedness between Islamic and conventional markets as well as between different jurisdictions. Another important factor that should be cited is the way it can assist in creating an Islamic benchmark yield curve in the future and so become an important facilitator of Asset-Liability Management for IFIs considering its short-term, easily tradable, liquid nature. Since Islamic markets are still dependent upon conventional benchmarks in their pricing of Islamic instruments means that IILM sukuk may well prove successful in building a Islamic benchmark curve for the industry. This is currently a feature lacking in Islamic finance.

Conclusion

Islamic Liquidity Management has been one of the most challenging tasks for IFIs as different countries have been trying to facilitate the operations of their local Islamic banking sectors. Even IILM-style initiatives such as the Liquidity Management Center in Bahrain have been established by a consortium of private banks and the IDB has made an effort to set up a short-term sukuk program to facilitate liquidity management for IFIs. Unfortunately, these initiatives have not proved successful so far. IILM is the first initiative which is supported by central banks and monetary authorities. On the other hand, IILM faces some Shariah-related challenges especially in the sense of the need to find a generally accepted Islamic structure both for the underlying sovereign asset pool and future short-term sukuk. This is in addition to technical challenges such as the financing of high quality sovereign assets to obtain a high rating, the necessity to manage the duration mismatch between short-term liability and long term assets in a shariah-complaint way . IILM has to therefore find innovative ways in accordance with Shariah principles and obtain its members` support so as to overcome these technical difficulties and solve associated problems. Another factor that can contribute to IILM`s success will be a wide acceptance and extensive support of industry players. Fruitful cooperation, collaboration and synchronization between IILM, industry players, central banks and monetary and regulatory authorities will be the key determinant and catalyst in order to foster and facilitate not only domestic, but also cross-border Islamic liquidity management.

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Turkey's Potential Role as a Global Leader in Islamic Banking and Finance

Humayon Dar*

Turkey possesses all the basic ingredients essential for becoming a global hub for Islamic banking and finance, which is known with a better term in the context of Turkey, i.e., participation banking. It has historical legacy of leadership of the Muslim world, has gone through a period of secularism, and has vibrant and growing economy that has a unique position of being part European and part Asian. By virtue of its geographical location, it enjoys the status of a bridge between Asia and Europe, and hence can serve as a bridge between the Islamic world and European continent. As other attempts in Europe to become a regional hub for Islamic banking and finance have seen only limited success, a window of opportunity has opened for Turkey to not only become a regional leader but also a global leader in Islamic banking and finance.

The biggest advantage that Turkey has over its competitors in Islamic banking and finance is in terms of the size of Muslim population and hence a potential domestic market. While Malaysia has emerged as a global leader in Islamic banking and finance, its growth potential is limited by its relatively small domestic market. Out of about 28 million people in Malaysia, only around 60% are Muslim. Another potential contender for global leadership in Islamic banking and finance, i.e., Saudi Arabia, has similar demographic credentials, with about 19 million Saudi nationals out of around 28 million people who live in the country. Again, domestic market size is rather limited. Other Gulf states also do not enjoy the benefits of large domestic markets, and hence can only serve as "off-shore" centres for Islamic banking and finance.

Other two countries that have potential to lead the global Islamic financial services industry are Pakistan and Indonesia, with huge domestic markets of about 190 million and 237 million people, respectively. With their populations being predominantly Muslim, Pakistan and Indonesia

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can assume global leadership in Islamic banking and finance, if other aspects of their economies are developed strategically. Indonesia is a declared secular country like Turkey, while Pakistan is an Islamic state, with the religion of Islam enshrined in its constitution. In both the countries, however, there is growing recognition of importance of Islamic banking and finance and its relevance to economic growth and development.

In the backdrop of all this, Turkey is on track to becoming the next hub for Islamic banking and finance. Turkey can very easily assume a leadership role in the global Islamic financial services industry by forming and leading a group of I-5, the top 5 countries with the potential of leading the global Islamic financial services industries. These countries may include: Saudi Arabia, Malaysia, Pakistan, Indonesia and Turkey. These countries are not necessarily the top ranked countries in the Islamic Finance Country Index (IFCI), developed and published annually by the London-based Edbiz Consulting. Nevertheless, they can be knitted together strategically to form a block that may be used for developing Islamic banking and finance as a tool for integration of financial sectors in these countries. Table below lists top 10 countries ranked by IFCI.

Countries	**IFCI Ranking**
Iran	1
Malaysia	2
Saudi Arabia	3
United Arab Emirates	4
Indonesia	5
Bahrain	6
Kuwait	7
Pakistan	8
Sudan	9
Banghladesh	10
Turkey	13

I-5 Group
Malaysia
Saudi Arabia
Indonesia
Pakistan
Turkey

The successful dollar-denominated \$ 1.5 billion sovereign Sukuk issue, followed by a lira-denominated \$ 900 million sovereign Sukuk in 2012 put Turkey on the global platform of Islamic banking and finance. This has generated a lot of vibes in Islamic banking and finance internationally, and it is expected that many Middle Eastern Islamic banks and financial institutions will enter the Turkish market in the future. Turkey has always been a country of interest in Islamic banking and finance. Kuwait Finance House (KFH) entered Turkey in 1989, even without an explicit commitment from the then Turkish government to provide a level playing field to Islamic banking. It is interesting to note that KFH's entry into Turkey long preceded its move into other markets like Malaysia, Bahrain and Jordan.

Despite personal encouragement by the then governor of State Bank of Pakistan (SBP), Dr Ishrat Husain, KFH did not enter the Pakistan market and remains reluctant. On the other hand, Albaraka Bank has been operating in Turkey since 1984, well before it entered the Pakistani market in 1991. This preference tells a story, which policymakers in Turkey must read before delineating a comprehensive framework for developing the country into a global player and eventually an international centre of excellence in Islamic banking and finance.

In the absence of a platform like I-5, the major contenders for the role of global leadership may enter into an unhealthy competition to attract Islamic capital. Admittedly, only a fraction of US\$ 1.63 trillion under management of Islamic financial institutions is mobile in terms of cross-border flows. Independent national approaches to Islamic banking, without an effective international coordination, are sub-optimal. Without a well-thought-of global strategy, it will not be surprising if Pakistan or Malaysia start feeling threatened by Turkey that is better suited in terms of becoming a destination of preference for many Middle Eastern investors who currently invest in Pakistan and Malaysia. This is particularly important as for many institutions in the Middle East it makes more logistic sense to do business in Turkey rather than travelling to the Far East.

The proposed member states of I-5 possess unique value propositions. Pakistan, for example, presents arguably the most conservative model of Islamic banking in the world, based predominantly on Hanafi school of Islamic jurisprudence, which takes a rather conservative view in matters related to business and finance. There is a definite value proposition that Pakistan may offer to other members of the proposed I-5. Indonesian economy, being one of the fastest emerging markets in the world, must offer an array of economic opportunities to the Islamic financial institutions seeking Islamic financial assets. Malaysia is now in a position to share its expertise and experience in developing the most comprehensive regulatory framework for Islamic banking and finance. It is proposed that Malaysia should play a lead role to develop a comprehensive framework for an IBF (Islamic Banking and Finance) Passport for the Islamic financial institutions to operate freely in the member states of the proposed I-5. Saudi Arabia is in need of liberalisation of economy and the proposed I-5 offers it an opportunity to adopt an Islamic approach to liberalisation of financial sector. Turkey's leadership role in the I-5 can be maintained if the secretariat of the proposed group is located in Istanbul.

It is important for all the five countries to show more commitment to Islamic banking and finance and use it as a strategic tool to attract funding for a number of infrastructural projects (e.g., Jakarta Metro, electricity projects in Pakistan, etc.) that need external financing. Through adopting a combined leadership role in Islamic banking and finance, the proposed I-5 can serve as a financial powerhouse in the Organisation of Islamic Cooperation (OIC) block. Previously, a number of the OIC-level projects came to Pakistan, e.g., International Islamic Chamber of Commerce and Industry, which either failed or moved to other countries because of lack of support and commitment from the Pakistan government. Hence, it is important that the such new projects are initiated on the I-5 level so that right kind of support could be solicited from the member states, in case a host country faces some problems in implementing and operating such projects.

Given the growing interest in Islamic banking and finance in Turkey, it is perhaps a good opportunity for Pakistan, Indonesia, Malaysia and Saudi Arabia to bring the government of Turkey on board to form the proposed alliance. The more experienced members of the group can share their expertise in the field of Islamic banking and finance with those who lack such experiences and expertise. While the likes of Malaysia have invested millions of dollars to set up institutions like INCEIF to develop required human resources for Islamic banking, Pakistan can develop a state-of-the-art centre of excellence for Islamic finance by investing a small amount in Darul Uloom Karachi, developing it into a teaching and research university specialising in Islamic banking and finance. If Turkey and Saudi Arabia can also play a role in this project, it would be a fantastic way of starting an everlasting collaboration in Islamic banking and finance amongst the countries involved.

The Darul Uloom model of education is certainly more cost effective as compared with INCEIF, which has a huge annual budget. Close cooperation between Pakistan, Malaysia and Turkey can prove to be an efficient way of producing talent for the global Islamic financial services industry if right channels are created and maintained amongst respective parties. In fact, INCEIF could be developed an I-5 level project, which could be more cost effective and efficient than the existing structure of INCEIF.

Education is only one area for cooperation. The real benefits will accrue if the IBF Passport is developed for unrestricted operations for Islamic financial institutions across the I-5 block.