CONCEPTUAL FRAMEWORK OF ISLAMIC BANKING & FINANCE: AN ALTERNATIVE APPROACH BASED ON EXISTING MODELS

ABSTRACT

Islamic banking industry is tremendously growing worldwide and no exception in the case of Malaysia. Malaysian Government is very supportive for the development of the Islamic banking and to ensure that Malaysia will become the center and the heart of the Islamic banking and finance. Even though, the rapid growth of the Islamic banking in Malaysia, it has been criticized for fulfilling or discharging the responsibility of Islamic institutions. A few researchers such as Halim and Chapra have come out the Islamic banking models. However, in the researchers' opinion, these models need to be modified after considering the current Islamic banking practices and so far, no research has been done on it. Therefore, the purpose of this research is to propose the alternative conceptual framework on which true Islamic banking should be founded. It is believed that this research will provide a foundation to further research in Islamic banking and finance.

KEYWORDS: Islamic banking, Islamic banking models, Halim model, Chapra model, Conceptual framework

1.1 INTRODUCTION

Banking is the main support and backbone of any country economy and any country is not being able to escape from baking system. However, the practices of conventional banking system are unlawful and prohibited from the Islamic perspective. The main reason for prohibition is due to *riba* (interest) and hence, for the *muslims*, it is necessary to have Islamic banking system. Many researchers have conducted the research in Islamic banking and finance and most of the researchers have looked at the efficiency and profitability of Islamic banks. So far, to the researchers' knowledge, no researcher has introduced the conceptual framework on which true Islamic banking and finance should be founded on. Hence, the objective of this research paper is to propose the Islamic banking and finance conceptual framework after critically reviewing the existing models and criticisms of current Islamic banking practices.

The organization of this paper is presentation in five sections. The second section explains the existing models of Islamic banking and finance and their comparison. The third section highlights the major criticisms of the current Islamic banking practices. The fourth section proposes the conceptual framework of Islamic banking and finance after critically reviewing the existing models and taking into considers the problems of current practices. The last section concludes.

2.1 EXISTING MODELS FOR ISLAMIC BANKING AND FINANCE

Under this section, mainly two models, i.e Halim model and Chapra model will be discussed. In addition, comparison of two models will be elaborated.

2.1.1 THE HALIM MODEL

Islamic banking has to be located in the Islamic scheme of things in order to determine the *Shariah* framework for Islamic banking and finance (Halim, 2008). According to him, Islam is basically divided into three main branches, *Aqidah, Shariah,* and *Akhlaq*. *Aqidah* relates to all matters of faith in Allah s.w.t, the Creator Muslims worship, His characteristics, our fundamental faith in Him and our belief in His commands. *Akhlaq* deals with the higher behaviour of Muslims, his character as required of him. *Shariah* are the rules Muslims live by coming from two principal sources, the primary and secondary sources. The primary sources will be the textual authority from the Quran and the Sunnah; whilst the secondary sources will be from *ijma', ijtihad* and *qiyas*. According to the rules of *usul fiqh, ijtihad* is further refined into its various categories including, *istihsan*[1]*, istishab*[2]*, sadddhara'i*[3]*, maslahah*[4], and *'urf*[5].

Shariah is divided into two broad categories namely *ibadat* and *muamalat*. *Ibadat* refers to the rules of worship or in other words man-to-Allah concerns whereas *Muamalat* refer to rules of man-to-man relationship. *Muamalat* is however not specifically confined to economic rules but encompass also political and social rules. However in modern times it is more popularly associated with business and commerce so much so that Islamic law on commerce is called *Fiqh Muamalat*. This is the branch where Islamic banking and finance fits in i.e. under *Muamalat* (Halim, 2008). However there is another subheading Islamic banking falls under which is less emphasized and often forgotten and that is *Iqtisad Islami* or Islamic economics. This is the crux of much of the problem with the debate on the efficiency or otherwise, the accuracy or otherwise of Islamic banking today. A discussion where Islamic banking is not placed in its proper context or if the context is addressed, is widely different interpretations thereof. For example Halim certainly did not forget the context of Islamic economics within which Islamic banking falls. He eloquently described that the Islamic Economics system falls into three sectors, the *Siasi*, the *Tijari* and the *Ijtimai* sectors (Halim, 2008).

[1] Giving preferences to one of many conceivable solutions to a particular problem in the light of considerations of equity and fairness (Saleem, 2009)
[2] Presumption of continuity (Saleem, 2009)
[3] Blocking the means to an unlawful act (Saleem,2009)
[4] Public interest (Saleem, 2009)
[5] Customary (Saleem, 2009)

The *siasi* sector is the public sector that establishes the laws and regulations, implement economic policies and manage assets, which are under state ownership. The relevant institutions here would be the government economic departments and statutory bodies whilst the law covered will include commercial, company and tax laws. The *Tijari* sector is the private sector, which essentially is the *muamalat* sector. This sector is involved in the creation of wealth encompassing the whole spectrum of economic activities from production to distribution and consumption. The components units of this sector will be the economic company and enterprise units. The laws that will govern this sector will be *Fiqh Muamalat*, specifically, rules on *Mudarabah, Musyarakah, Bai, Bai Bithaman Ajil*, *Murabahah, Ijarah, Rahn and Kafalah* to name a few.

Under Halim's Islamic Economics framework there is a third sector called the *Ijtimai* sector or the social welfare sector. This is the sector said to carry the responsibility for the social welfare of the *ummah,* for example deliverance of Islamic social security. The component organizations will include *Bait al Mal* and *Bait al Zakat* from the public sector side; and the charities and social welfare organisations from the private sector side. The relevant *ijtimai* laws will include *Fiqh* on *Zakat, Waqf, Sadaqah* and *Qard Hasan*. Islamic banking and finance clearly falls under the *Tijari* sector and Halim absolves the *tijari* sector including Islamic banks of much social responsibility, and places the responsibility largely on the shoulders of the *ijtimai* sector. However he does concede that as corporate citizens the *tijari* component units must carry certain responsibilities towards the *siasi* and *ijtimai* sectors.

An important element of the Halim model is the complete justification of using debt financing in Islamic banking. In fact it is perfectly acceptable for the entire Islamic banking system to be based solely on debt. Halim relies on the principle of trade to justify debt financing in Islamic banking.

Halim uses the following verse to justify debt financing in Islamic banking, *Surah Al- Baqarah ayah 275* and he explains the commercial practices in the pre Islamic days need to be understood. Commerce and trade is well developed even before the advent of Islam. The Arab traders of *Hijaz* practiced debt financing as understood today in equal propensity with *riba* lending and borrowing. In fact the term *riba*, literally coming from the word increase, came from the practice of the traders asking the debtor, be they debtor from *riba* loan or debtor from debt financing, whether they want to make payment on the due date or to extend the period of debt in which case they are to pay an increase or *riba*. This practice is so common it led to *Ibn al 'Arabi* identifying the tribe of *Thaqif* as the one whom infamously claimed that trade is similar to *bai'* which led to the revelation of *ayah 275*. The interpretation by Halim of *ayah 275* is that whilst many focus on the *ayah* as the *raison de terre* for the prohibition of *riba*; it is also the *ayah* that validates debt financing as *Shariah* compliant. For if what is haram is to ask for *riba* at the end of a debt financing period, Halim argues that the debt during the debt financing, and the concept of debt financing itself must be implicitly halal. Halim argues that the debt financing used here would be the *Bai Muajjal, Bai Murabahah*, and *Bai Salam* in the purchase and sale of commodities and goods. Hence Halim's validation of current practices of Islamic debt financing today by *ayah 275 surah al Baqarah.*

2.1.2 THE CHAPRA MODEL

The other group led by Chapra, Siddiqui, Sadr, Rosly, Dusuki and Haron to name a few takes the view that Islamic banks should embody the principles as espoused by Islamic economics - the Chapra model (Asyraf, 2008). In other words like other institutions in the Islamic economy the Islamic banks have an apparent and equal responsibility to help achieve economic justice, fair distribution of wealth, and upliftment of the plight of the poor. In the Chapra model Islamic banking is seen as part of the Islamic economic system. Therefore as for Chapra's model of Islamic banking it will uphold the objectives of Islamic economics (Chapra, 2008). He outlines four goals and values for Islamic economics namely:

1) Economic well-being within the framework of the moral norms of Islam.
2) Universal brotherhood and justice
3) Equitable distribution of income
4) Freedom of the individual within context of social welfare.

From each objective the characteristics of the Chapra Model may be derived. In the first objective the emphasis is on the moral norms of Islam. This suggests a deliberate desire to achieve Islamic moral norms in the Islamic banking system. The safest definition of Islamic moral norms would be the objectives of *Shariah* or *Maqasid Shariah*. Therefore it may be concluded that the Chapra model seeks achieving *Maqasid Shariah* as an objective of the Islamic banking system. The second objective in the Chapra economic model begins with the emphasis that all men are created equal and therefore there must be justice in all man-to-man relationship. By extension in Chapra's model of Islamic banking justice between banks and its customers are of paramount importance. An Islamic bank cannot take the position of the conventional bank with their customers where conventional banks tend to treat their customers with much injustice. The third objective of equitable distribution of income means the Islamic banking system cannot perpetuate activities which defeats or does not contribute to this objective. There must be wide distribution of wealth and the Islamic bank must not contribute to concentration of wealth in the hands of the rich. The fourth objective of Chapra Islamic economic system is the freedom of individual within the context of social welfare. Chapra believes in the freedom of the market system but modified as necessary to make it conforms with the ideals of Islam as much as possible. By extension the Islamic banking system according to Chapra must also conform to the ideals of Islam as much as possible.

2.1.3 A COMPARISION OF HALIM AND CHAPRA MODELS

The researcher finds there are common factors in situations when two groups take opposite positions on an issue, especially in relation to discussions on the role of Islamic institutions imposed into a largely secular environment, as Islamic banking was imposed into a largely conventional banking environment. For example the opposite views of the proponents of Halim model versus the proponents of the Chapra model of Islamic banking. One factor is the argument from the practical implementer faced with the practical hurdles at hand as epitomize by the proponents of the Halim model who were practitioners of Islamic banking implementing Islamic banking into society; the other would be the group who argues what should be, compared to the shortcomings of what is, in the current alien environment as epitomized by the proponents of the Chapra model who were generally not directly involved in implementing Islamic banking into society .

The environment Islamic banking is operating in must be acknowledged. Once the impact of the environment is acknowledged then there are common grounds to begin to find a solution to the problem at hand. Whilst the Halim view can be appreciated coming from the point of view of a pioneer in implementing Islamic principles into real life, the researcher humbly suggests however that in the said model a particular point may have been overlooked. That is, in the Halim model, has the *Tijari* sector economic unit in the form of the Islamic Bank, shed profit maximization as its driving objective, and replaced it with human welfare maximisation as required in an Islamic economics system. Whilst social welfare is the prime responsibility of the *ijtimai* sector; it cannot be that the economic unit in the *tijari* sector still practice profit maximization as its underlying driving objective. However if this is Halim's contention, that the *Tijari* unit can practice profit maximization and the *ijtimai* unit will compensate for whatever social welfare shortfalls in the *tijari* sector then it can be seen how this point of view will and does clash with that of the Chapra model. The Chapra model seems to take the stand that whilst the *Ijtimai* units delivers social welfare, the *tijari* unit by default will do their part in contributing to social welfare because as operating units in an Islamic Economics system they can't help but adopt human welfare maximization as the underlying objective in place of profit maximization.

The line of argument above presupposes that profit maximization as the sole and single objective is inadequate. Profit maximization is the underlying sole objective in a *riba* driven economic system where equitable distribution of wealth is not an economic objective. A principal weakness of this system is that by its implementation the rich gets richer, the poor gets poorer, and ever widening income gaps between the rich and the poor is the constant end result of this system (Mirakhor & Smolo, 2010). According to a UN sponsored study by the World Institute for Development Economics Research, in the year 2000 one billion people were living on less than USD1 per day. The per capita GDP (total national output divided by the population), difference in income between the world's richest countries and the world's poorest countries, which was 22 times in 1913 is now 267 times. 1% of the world's population now own 40% of the planet's wealth. "The study emphasized that economic growth is, by itself, no fix: How the gains are distributed is just as important. In China, Romania, Sri Lanka and many Latin American countries, swiftly expanding economies have improved incomes for many, but the benefits have been limited by a simultaneous increase in economic inequality, putting most of the spoils into the hands of the rich and not enough into poor households...".(Davies, Sandstrom, Shorrocks & Wolff, 2008). This is the problem with profit maximization, delivers economic growth but with much inhumanity.

So in the debate between the Halim and Chapra models, the argument hinges on whether the *Ijtimai* sector in the Halim model can deliver enough social welfare as defined and demanded by Islamic Economics, in spite of the *tijari* sector practicing profit maximization as its underlying objective. Apart from the loopholes in these models, current Islamic banking practices have been criticized by the scholars. The following section will explain these criticisms.

2.2 CRITICISMS ON CURRENT ISLAMIC BANKING PRACTICES

In this paper, two main issues related to debt financing and overstretching of the principle of trade in today's Islamic banking are discussed.

2.2.1 DEBT FINANCING

There has been much criticism on the over use of debt financing principles in Malaysian Islamic banking (Wong, 1995; Samad, 1999; Rosly 2003) so much so it borders on the accusation that debt financing is not *Shariah* compliant. However, many take the view that debt financing is nonetheless a valid financing principle under *Shariah*. None justifies debt financing better than Halim as discussed above, where he used *Surah Al-BaqarahAyah 275* to justify the debt financing in Islamic banking.

2.2.2 OVERSTRETCHING OF THE PRINCIPLE OF TRADE IN TODAY"S ISLAMIC BANKING

The Researcher suggests that current critics of Islamic Banking in Malaysia today do not criticize the principle of Islamic debt financing but perhaps the interpretation and application thereof of Islamic debt financing principles by Malaysian Islamic banking practitioners could be erroneous (Mirakhor & Smolo, 2010). It is erroneous because the Researcher suggests that many Islamic banks today wants Islamic financing principles to deliver the exact risks and rewards of conventional products and this is usually done via unfettered clauses in the legal documents (Muhammad Akram Khan, 2005). This led to the overstretching of the definition of trade so much so it is currently difficult to recognize the principle used as trade. The following are examples of what is meant by the overstretching of the principle of trade.

2.2.2.1 EXCESSIVE TRADE CREDIT PERIOD

In the days before the revelation of *Surah Al Baqarah ayah 275* the debt financing refers to the credit period given by the supplier for the purchase of commodity and goods and the credit period could not have been too long. Today the trade is a purchase of a house by the customer from the Islamic bank and the credit period given by the bank can be as long as 30 years.

2.2.2.2 A VALID TRADE IN SHARIAH REQUIRES ASSET TO BE POSSESSED BY BUYER BEFORE HE CAN SELL TO ANOTHER PARTY.

The sale of a house by an Islamic bank to a customer presupposes that the Islamic bank purchase the house first before selling to the customer. In reality the Islamic bank insists the customer purchase the house first from the developer; only then will the bank purchase and resell the same house to the customer. There are three trades here to achieve the financing effect. The sale and resale of the house to the customer raises the issue of *Al-'Inah*or reflection of *riba*. Reliance is placed on the *Shafie* position of allowing such contracts on the grounds that hidden intentions should not be sought as long as the contract fulfills its pillars. The Malikis and *Hanbalis* however consider such contracts unlawful on the grounds of *Sadd Dhara'i* or blocking the means to arrive at a *haram* position (Saleem, 2009). To purchase the house from the developer the customer usually makes a ten percent down payment upon signing the Sale & Purchase agreement with the developer. It is arguable whether the customer has achieved *qabdh* of the house before reselling it to the bank (Engku Rabiah, 2006).

2.2.2.3 NO PREPAYMENT PENALTIES IN REAL TRADE

When a customer makes an early payment of an installment of the selling price of an asset purchased from the bank, the customer is sometimes penalized by having to pay a prepayment penalty. In a trade it is not conceivable the flour supplier for example will penalize his customer for settling the price for the credit sale of the flour early.

2.2.2.4 REPEATED TRADES TO ACHIEVE A FINANCING TRANSACTION

In *Tawarruq*, Commodity Murabahah and *Bai 'Inah* dubious series of sales of assets and commodities are effected to achieve a financing effect. For example in *Tawarruq* to deliver cash financing to a customer, the bank first buy metal from a metal trader. The metal is then sold to the customer at cost plus profit margin. The customer shall pay the price to the bank at an agreed date in the future. The bank then helps the customer to sell the metal on the market so that the customer will get cash.

2.2.2.5 BUYING AND SELLING THE SAME ASSET PERIODICALLY, SAY EVERY THREE MONTH TO DELIVER A FLOATING RATE FINANCING FACILITY TO THE CUSTOMER

In revolving BBA repeated trades of the same asset is used to achieve the required financing effect. In order to deliver a floating rate cash facility to a client some Islamic banks sometimes transact on the same asset at intervals of say, every three months so the the client pays different prevailing rates every three month. This can be said to approach a *tala'ub* or sham transaction (Securities Commission, 2002)

2.2.2.6 TA'WEEDH

Ta'weed his allowed by the scholars for deliberate non-payment of selling price installments; however an investigation must be done first to determine the financial position of the debtor. Today it seems no investigation is ever done by Islamic banks and *ta'weedh* is treated exactly like the conventional penalty interest.

The above are just some of the overstretching of the principle of trade today. If trade is to be the principle to replace *riba* lending then subscription must be made to the true definition of trade in our Islamic Banking practice.

Also if *ayah 275* to *ayah 280 of Surah Al Baqarah* is to be the basis for the credibility of Islamic banking practice today, in the researcher's opinion the whole set of the verse must be adopted by the Islamic banks and this include *ayah 280* with the injunction to assist the debtor in strained circumstances and the readiness and willingness to give as alms of what is due to the Islamic banks. If there is reluctance to adopt *ayah 280* by the Islamic banks then one may question their right to use trade as a principle to support Islamic banking practices; one can't pick and choose which of God's injunction to use and which to not use.

In spite of all the criticisms on Islamic banking, acknowledgement must be made that the implementation of Islamic principles into banking and the daily life of the *ummah* is such a glorifying effort which must be praised. At the same time, it has to be recognized that the modern banking and financial system is almost completely different from what was found in the early days of Islam. Thus, the next section will present an alternative approach to develop the conceptual framework of Islamic banking and finance.

3.1 PROPOSED CONCEPTUAL FRAMEWORK OF ISLAMIC BANKING AND FINANCE: AN ALTERNATIVE APPROACH

Islamic banking and finance cannot exist in a vacuum; it must be part of a financial system and this financial system must be part of an economic system. Therefore if a judgment is to be made on Islamic banking and finance system it cannot be done ignoring the characteristics of the financial system it operates in and in turn the economic system the financial system operates in. If Islamic banking is judged ignoring the environment it operates in, the conclusion can be erroneous. However before the discussion on the subject of negative impacts of the environment on the workings of the Islamic banking system it is necessary to describe the expected environment it should be working in based on our understanding of *Shari'ah*. Once this wider perspective is gained on the expected environment Islamic banking should be working in and is compared that to the environment Islamic banking finds itself in today then it will be easier to appreciate the possibility of existence of the negative impacts of the environment on the performance of Islamic banking today. To summarize Islamic banking should be part of a sole and single Islamic financial system operating in an Islamic economy in a nation governed by *Shariah* laws. What is found today is an Islamic banking system enveloped and outsized by a *riba* banking system operating in an essentially conventional and *riba* driven economy in a nation governed by man-made laws. This is not a value judgment by the researcher but a statement of fact of the environment Islamic banking finds itself in today. Thus it is now incumbent to define the expected environment Islamic banking should be operating in. Islamic banking should be a sole and single banking system operating in a sole and single Islamic Financial System operating within the realms of Islamic economics. It is Islamic economics which will define the shape and form of the Islamic financial system, and which in turn will define the shape and form of Islamic banks (Chupra, 2008; Asyraf, 2008).

If it is acknowledged that the subject of Islamic economics have been meticulously drawn by the early *ulama*' and the more modern Islamic economists experts from the textual authority of the *Quran* and *Sunnah*, and the secondary sources of *Ijma'* and *Ijtihad* (Muhammad Khan, 2005) then it follows that the resultant Islamic financial system and the resultant form of Islamic banks as defined by Islamic Economics must be the ones endorsed by *Shariah* (*see* Chart 4). So it is incumbent to define what Islamic economics is.

Islamic economics cannot be discussed without going into the entire philosphy of the religion behind it (Mirakhor, 1995; Siddiqui, 2005). *Surah Al-An'aam Ayah 162* states: "Say: Truly my prayer and my service for sacrifice, my life and my death, are (all) for God, the Cherisher of the worlds. No partner has He. This I am commanded and I am the first of those who bow to His will". So important is this *ayah* Muslims are required to recite it at the beginning of each prayer. In essence the *ayah* stresses that the Muslim's life and death is for the Creator, which means there is no part of the Muslim's life which is separate from the religion of Islam (Mohamed Ariff, 2005). Every aspect and every facet of the Muslim's life is for and in, the service of God and that include his economic activities (Kahf, 1989). And to support the *ayah* is a Hadith narrated by Abdullah bin Mas'ud, where the Prophet pbuh says, everyone on the day of judgment shall be questioned on the following, his life, how he expended it; his strength how he used it; his wealth, from whence did he earns it, and to where did he spend it; his knowledge, how he used it (Mirakhor, 1995). Therefore to the Muslim, religion is not confine to rituals but the act of living itself is religion, and must be for the service of Allah and that would include one's economic activities. An economic system that is borne out of this philosophy must have objectives and characteristics vastly different from conventional economics (Muhammad Arif, 2005). The first pillar of Islamic economics is that the world is literally owned by God (Kahf, 1989) (*see* Chart 5). This has implication on how the Muslim looks at wealth and ownership thereof. Man owns nothing absolutely and holds wealth on trust for Allah s.w.t and has to account for how he deals with it in the hereafter. Wealth or resources is not scarce and if it is acquired without sacrificing spiritual ideals there is no reason to avoid wealth (Chupra, 2008). The second pillar is God is one and every other thing is created (*see* Chart 5). This means all humans have the same origin and belongs to no classes. There is no inborn superiority of man over man by virtue of race colour or creed. The best in the eyes of God is one with the highest *taqwa* (piety). The third pillar is belief in the day of judgment (*see* Chart 5). This means the time horizon for Man extends to the hereafter; and the cost benefit analysis he does to base his economic decisions on takes into account the effects in the hereafter (Kahf, 1989). Ayah 2 and 3 of Surah AlBaqarah states *" This is the Book; in it is guidance sure, without doubt, to those who fear God. Who believe in the Unseen, are steadfast in prayer, and spend out of what We have provided for them.".*Belief in the pillars outlined above is to be understood within the context of these Quranic injunctions. Let's pause and benchmark these pillars against Islamic banking today. Firstly the deposits at the disposal of the Islamic banks today are therefore wealth they hold on trust for Allah s.w.t and accountable thereto in the hereafter. Based on the second pillar the best Islamic bank today is not the most profitable one, but one which exemplify the highest *taqwa*. Based on the third pillar long term planning for the Islamic bank will not run into number of years into the future but will run into the hereafter.

Even based on these initial definitions and description of Islamic economics it can be seen that the Islamic bank and Islamic banking expected by *Shariah* is going to be vastly different from the organizations seen today. It is important to note here that an Islamic bank is not a *mukallaf*. A *mukallaf* or one who is accountable to Allah swt must be a human. It is offered that a *mukalla f*in the context of an Islamic bank are its shareholders, directors, management, staff, customers, regulators, law makers, the State itself, in short the entire Muslim *ummah* the Islamic bank operates in (*see* Chart 6).

Islamic economics further operates on three main principles, principle of ownership, principle of balance and principle of justice (Kahf, 1989) (*see* Chart 7). Under principle of ownership the crucial point is that ownership by man is confined to life only, upon death wealth is distributed as specified by God i.e. the laws of *far'aid* or Muslim estate distribution. A clear objective of *far'aid* is to break up concentration of wealth. Therefore an implication of this pillar of economics is that Islamic banking cannot assist in concentration of wealth. Its activities must lead to wide distribution of wealth. If focusing on debt financing results in concentration of wealth then the Islamic bank must drop debt financing and focus on equity financing.

On the principle of balance, moderation is to be expressed in all aspects including consumption, and consumption is not an end in itself (*see* Chart 7). The principle of moderation therefore precludes the Islamic bank from adopting profit maximization as its principal objective. As a unit in the Islamic economy an Islamic bank is required to adopt human welfare maximization as an objective instead of profit maximization.

However of the principles of Islamic economics probably the most relevant to Islamic banking is the principle of justice (*see* Chart 7). Justice is the third oft repeated word in the Quran after Allah and knowledge. Justice is applied in all aspects of economic activity and is therefore expected to be observed in all aspects of Islamic banking. This means justice in the relationship between bank and customers; justice in the allocation of risks between banks and customers, and justice in the clauses of the legal agreements between bank and customers.

Having discussed the philosophy and principles of Islamic economics, the rules and parameters demanded by Islamic economics and their impact on the form expected of the Islamic banking system and Islamic banks today, needs to be outlined.

First is the prohibition by law of *riba* (*see* Chart 8). What this means is that the Islamic banking system will not be working side by side with *riba* banking as seen today; it will operate as a sole and single system in a sole and single Islamic financial system operating in a *riba* free economy.

Secondly the economy will be a *qirad* or *mudarabah* driven economy instead of a *riba* driven economy (*see* Chart 8). This means there is no lending in this economy, all aspects of the economy move on the principle of profit sharing. This now begs the question what will be the form of Islamic banks and Islamic banking system within these parameters of the economy. It is obvious that the Islamic bank will be an equity driven bank, taking deposits on *mudarabah* and extending investments on *mudarabah* and *musharakah*. Every other bank and institution will also be operating under the equity principle of *Mudarabah* and *Musyarakah* as are all the economic units in the economy. The Islamic banking system will therefore also operate under *Mudarabah* and *Musharakah* (Mohammed Ariff, 2005).

The third parameter in Islamic economics is the guarantee of debt payments by the state (*see* Chart 8). What this means is that if debtors are unable to settle their debts they will be one of the *asnafs* eligible to get their debt settled from *zakat* funds. This also means that upon death the government undertakes to settle all debts of its citizens if the citizen's estate is insufficient to settle the debt. The position need to be considered if the debtor left a house debt financing not yet settled with the Islamic bank whether the government will settle his bank debt financing. Today in Malaysia there are billions of Ringgit owed to the banks under house debt financing; the position will have to be considered whether the government in an Islamic economy will settle all these debts on behalf of its citizens who passed away with not enough money to settle their debts. The answer to this question can only be one of two. First the rules are rewritten and decision made the government is not responsible for debts owed to Islamic banks; or the rules are interpreted strictly such as to arrive at a decision that debt financing is not acknowledged by *Shariah* and the only debts the government will settle for its citizens will therefore be consumption debts i.e. *Qardh al-hasan* loans the citizens borrow for desperate consumption needs. This makes sense and fits in with the government's undertaking to settle its citizens' debts if they are unable to settle it themselves. It is not conceivable that the state will undertake to settle all debts due by the citizens to the banks.

The fourth parameter is the guarantee of a minimum standard of living by the state (*see* Chart 9). This is a form of social insurance implemented by the government in the Islamic economy. This policy is however implicit by the operations of the *zakat* system where the *asnafs* eligible to receive *zakat* are namely the poor and needy, the *zakat c*ollectors, the new converts to Islam, liberation of slavery, those in debt, for the cause of Allah, and the wayfarer. The implication of this parameter is that the state must collect the *zakat* and distribute to the *asnafs* mentioned above. As far as the Islamic banks are concerned apart from their clear duty to pay *zakat* on their earnings the Islamic banks like other institutions in the Islamic economy must contribute towards the achievement of a minimum standard of living for all citizens (Asyraf, 2008). The position has to be considered whether the Islamic banks can do that apart from paying *zakat*. In the Islamic economics model the Islamic bank is expected to do more than paying *zakat*; the Islamic bank is expected to help achieve a minimum standard of living and other objectives of *Shariah* (Muhammad Arif, 2005) (*see* Chart 10). It would appear tough for the Islamic bank to achieve this if profit maximization is still its overriding objective. Therefore one of the extensions of the parameters of Islamic economics is to replace profit maximization with something else more appropriate for an economic institution in an Islamic economy.

The replacement Islamic economists have identified is maximizing human welfare (Muhammad Arif, 2005). Human welfare needs to be defined in a widely acceptable formula so that choices and decisions to maximize it can be made in an Islamic economic system. What the Islamic economists have found to their delight is that this hard to pin down human welfare function have been addressed and laid down by two great Muslim thinkers: Al-Ghazali and Al-Shatibi (Zarqa, 2005) (*see* Chart 11). Al-Ghazali (died 505H) first gave the original formulation; Al-Shatibi (died 790H) greatly developed the concept. The starting point for this human welfare function is that Islam sets goals for human life. All matters that achieve these goals increase human welfare. They are called *masalih* or utilities; the opposite is *mafasid* or disutility. Al-Ghazali and Al-Shatibi conclude that human welfare in Islam can divided into a three level hierarchy, essentials (*Al-Dharuriyyat)*, exigencies (*Al-Hajiyyat*), and embellishments (*Al-Tahsiniyyat*) which have been discussed in some detail earlier. The scholars have identified five fundamental values of Islam which is essential to preserve namely, religion, life, property, intellect, and lineage, and focus on the *Shariah* objectives with respect to property as this would be the realms of economics.

The human welfare function in Islamic economics has to encompass all the *Shariah* objectives in respect of property. If the Islamic bank then adopts this human welfare function to replace profit maximization, as its objectives then the following are issues it must address:

i) Protection of wealth in its wide sense and prohibition of destruction of wealth, even one's own;

Islamic banks today would not appear to have much difficulty in observing this objective. They need to be mindful however their fiduciary duty to look after pledged assets of their clients now goes beyond fiduciary but is a command under *Shariah*. In situations of protracted default, pledged buildings and other properties must not be allowed to deteriorate and get into a decrepit state. Auction sale of pledged assets must be at the best time and best price available to the customer.

ii) Prohibition of transgression against property of others.

In normal banking operations it cannot be seen that Islamic banks are operating in a manner that transgresses against property of others. However the now famous claim that seignior age of fiat money is theft of the highest order can hardly be ignored (Meera & Larbani, 2009). If indeed it is theft then Islamic banks operating in a fiat money system is also guilty of that theft. Fiat money means money not backed by Gold, as was the case before 1971 under the Bretton Woods system. Under Fractional Reserve Banking (FRB) a bank needs only to retain a small amount of a say, RM1000 deposit, the balance can be given out as financing facilities to clients. When the financing client deposits the financing amount it receives in another bank; the FRB system starts again with new money created out of nothing by the second bank when it extends new financing to another client after retaining the small reserve requirement. Mathematically a RM1000 deposit can create RM25, 000 of new money out of nothing. Since the amount of real goods and services in the economy remains unchanged at RM1000 this creates inflation. Therefore in for example a *Murabaha* transaction when the Islamic bank purchases the goods on behalf of its customer before selling it to the customer, using the new money it actually "steals" ownership of the goods by paying for it with money created out of thin air. Ultimately the *ummah* unwittingly is made to pay for this theft through inflation, or in other words a loss in their purchasing power. A cold hard look at this phenomena brings one to the conclusion that the Islamic bank have transgressed wrongfully on the property of the *ummah* if it continues to operate under the fiat money and FRB system. To avoid this wrongful transgression against the property of others an Islamic bank may only operate under a Gold Standard system or any system where creation of fiat money via fractional reserve banking do not exists.

iii) <u>Equitable distribution of wealth</u>

An Islamic bank is also responsible to contribute towards an equitable distribution of wealth in society. This means the Islamic bank must be constantly conscious of the effect of its decisions and policies on the equitable distribution of wealth in society. If it chooses to focus only on debt financing where banks tend to provide financing only to people who have ample assets as security then the bias will be to give financing only to rich corporates as they are the ones able to offer good collateral and a high level of paid up capital to comfort the bank. Small and medium sized enterprises or popularly known as SME's will be denied much financing as they will usually fail the collateral and paid up capital criteria benchmark. As a result of this strategy the rich corporates will get richer and richer and there will not be equitable distribution of wealth in society. Justice before production requires equal access to resources including monetary resources (Mirakhor, *ibid*)

iv) Wealth should benefit owner and community

Individuals may only use Allah's resources, which they temporarily own on trust for Allah, mindful of Allah's ultimate ownership and the right of society in those resources (Mirakhor, 1995). A simple illustration of this rule is that if one were to have RM1 million in wealth one is required to invest it in a project that creates jobs and other benefits to society, instead of buying a masterpiece work of art and locking it in a personal vault. It is difficult to see how an Islamic bank today can be guilty of allocating wealth only for the benefit of the owner. Much of the financing is usually for productive purposes, as new cash flow must be generated by the financing to service the bank. In this respect the Islamic bank must however be mindful of extending financing to individuals to purchase luxury mansions and super expensive cars, as it is difficult to see how these assets can also simultaneously benefit society.

v) Good circulation of wealth through approved transactions and *zakat, waqf* and *sadaqa*

Surah AlHashr ayah 7 states "….so that this wealth may not merely circulate between the wealthy amongst you." It is a clear objective in *Shariah* that a system cannot exist and transactions adopt such that the wealth of the economy circulates merely amongst the rich. This is one of the clear objections to the *riba* system where wealth continues to circulate amongst the rich. Therefore the Islamic bank must take cognizance that its operations, policies and preferred transactions must not by default ends up with wealth circulating amongst the wealthy only. Some argue that the preponderance of debt financing in Islamic banking tends to result in wealth being confined only to the wealthy when Islamic banks give priority of financing only to customers who are able to offer good collateral (Rosly, 2003). Conceivably this bias will disappear when Islamic banks provides equity financing.

vi) Encourage spending on needy

Islamic banks must involve itself in microfinance if it were to uphold this objective. A dislike to be involved in microfinance will not see the Islamic bank as upholding this rule.

Apart from the above rules which the Islamic bank must uphold if it were to migrate from profit maximization to human welfare maximization as an overriding objective the Islamic Bank must also take cognizance of the following other higher objectives of *Shariah*.

1) Establishment of justice
2) Prevention and eradication of evil and corruption (*fasad*)
3) Education of mankind
4) Maintenance of balance in human nature (*islah*)

4.1 CONCLUSION

In sum, it is obvious that all parties hinge their vision of Islamic banking on the textual authority of the Quran and Sunnah. All accept the prohibition of *Riba* as the platform to base the implementation of Islamic banking. What many differ in is the degree of Islamicity they attached their objectives of Islamic banking to. Halim appears to take the world as he finds it and fits in Islamic banking into the modern economy based on the legal maxim of *Al-'Asl Ibahah*. This means to accept modern concepts as acceptable unless they clearly contradict *Shariah* in which case the parts that contradict *Shariah* is to be rejected and replaced with parts that comply with *Shariah* (Saleem, 2009). Chapra on the other hand rejects this model and argues that Islamic banking must have objectives pegged to *Maqasid Shariah*. The researcher takes the Chapra view and expands it further based on the thoughts of other Islamic economists. In particular the researcher attempts to the draw into the Islamic Economic model, the details of the Islamic financial system in general, and the shape and form of the Islamic bank in particular. Since this is the conceptual framework, the limitation is this proposed framework has not been tested yet and thus, future research will be looking into the feasibility of this proposed framework.

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CHART 1 – THE HALIM MODEL

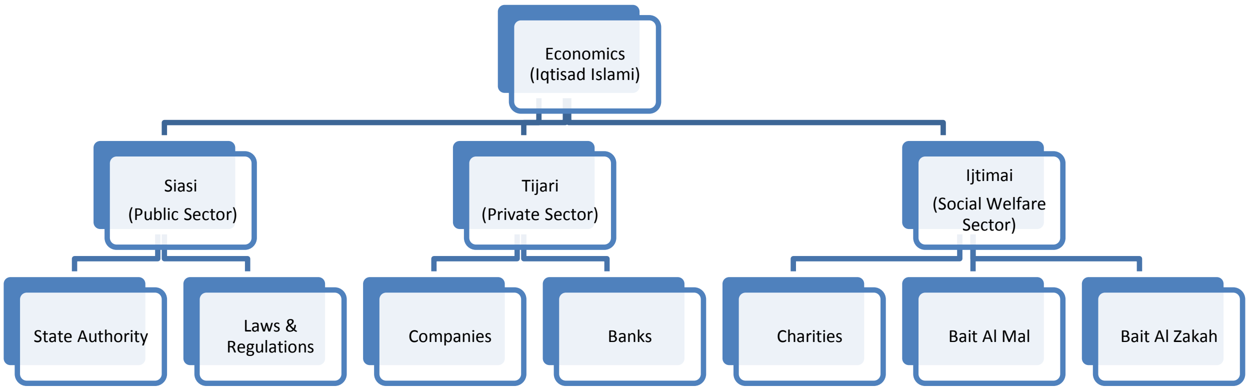
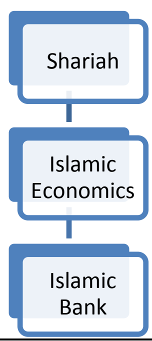


CHART 2 - CHAPRA MODEL



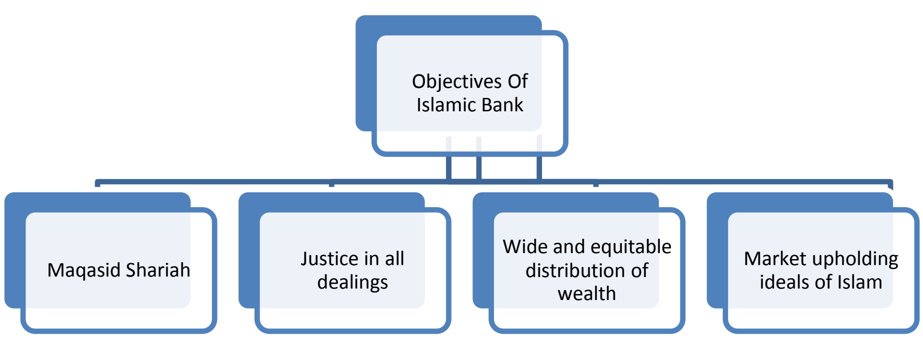


CHART 3 - IMPLICATION OF SHRIAH OBJECTIVES ON PROPERTY TO ISLAMIC BANKS

Protection of wealth and Prohibition of destruction of wealth	Required to take extra good care of customer's property
Prohibition of transgression against property of others	Cannot operate in fiat money system
Equitable distribution of wealth	Financing allocated equitably to all big and small enterprises
Good circulation of wealth	Abandon debt financing focus on equity financing
Wealth should benefit owner and society	Financing to activities that maximizes benefits to society
Encourage spending on needy	Extend microfinance