


**Considering the Dichotomy
between the Ideals and
Realities of Islamic Finance**

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**Why is Essentialisation of Islamic Moral
Economy Beyond Islamic Finance Necessary?**

- During the initial days of the recent financial crisis, a number of commentators talked about 'greed' and the 'irresponsible attitude' of the financial sector as being an important source of the problem.
- This opened up a new discussion on the importance of morale in economic and financial life.
- As part of the Islamic moral economy, Islamic finance provides a constructivist response for this.
- However, a critical examination of the developments and trends in Islamic finance indicates that the convergence has been from Islamic finance to conventional finance in terms of operations and functioning; and that Islamic finance, through its commercial banking and finance attitudes, does not necessarily uphold the spirit of Islamic moral economy.
- The financial crisis, being an extremely difficult lesson, should encourage us to overcome this apparent divergence and the growing dichotomy between the ideals of Islamic moral economy and the realities of Islamic finance.
- Thus, this lecture aims at locating the sources of this divergence and potential ways of overcoming it.



Why is Essentialisation of Islamic Moral Economy Beyond Islamic Finance Necessary?

- Islamic finance, which emerged as part of Islamic Moral Economy movement, has been gaining roots in the global financial system.
- While Shariah compliance in legal and mechanical terms is essential and important, the consequences of Islamic finance is also important to check if it fulfils the foundational principles and aspirations of Islamic finance.
- In this particular point, it seems that Islamic finance is moving in another direction by missing the value system of Islamic moral economic theoretic. Therefore, essentialisation of Islamic moral economy as a system is crucially important.



The Economic Challenge as Perceived by Islamic Moral Economy

How to realise such human well-being:

- **Conventional/Secular world-view:**
 - The market or central planning would itself rein self-interest and serve social interest without collective value judgements or spiritual accountability
- **Religious word-view:**
 - a. Well-being is not possible without removing conflict between self-interest and social interest and motivating individuals to fulfil their social obligations;
 - b. Socially-agreed moral values and spiritual accountability to rein self-interest in a way that would serve social interest.

•Result in the Modern World:

No modern society has been able to fulfil even the material needs, leave alone creating mental peace and social harmony.



Islamic Moral Economy: Emergence of Framework Paradigm

- In the opinion of the founding fathers, the failure of economic development in 1960s and 1970s was attributed to capitalist economic development strategies, which ignored the importance of human being and its well-being. Their objective was therefore to develop an economic system understanding, which could develop a human-centric development strategy.
- The Islamic Moral Economy paradigm aimed at the creation of the Islamic system of economics with its distinct values, norm, rules and institutions with a politically oriented systemic understanding.



Islamic Moral Economy: Emergence

- For Islamic Moral Economy ontological and epistemological sources is the *Qur'an* and *hadith*, which determine the framework of the economic value system, the operational dimension of the economy and also the behavioural norms of the individual Muslims.
- The axioms and foundational principles of Islamic Moral Economy define the framework for economic activity to take place within intra- and intergenerational social justice, which reveal themselves in the methodological framework of the Islamic economic system.
- Therefore it is based on a constructivist ideology, with the aim of forming an authentic Muslim identity as opposed to global dominance of capitalism, which has in reality failed in the economic development process.



Islamic Moral Economy: Values and Economics

It is a fact that no human endeavor is value-free, which implies that reality including economic reality is socially constructed.

- J. S. Mill (1836)

Political economy, therefore, reasons from assumed premises which might be totally without foundation in fact, and which are not pretended to be universally in accordance with it.



Islamic Moral Economy: Values and Economics

- J. S. Mill (1836)

Now in whatever science there are systematic differences of opinion ... the cause will be found to be, a difference in their conceptions of the philosophic method of the science, the parties who differ are guided, knowingly or unconsciously, by different views concerning the nature of the evidence appropriate to the subject. They differ not solely in what they believe themselves to see, *but in the quarter whence they obtained the light by which they think they see it (emphasis added).*

- Schumpeter (1954):

“Analytic effort is of necessity preceded by a pre-analytic cognitive act ... called Vision.”



Islamic Moral Economy: Values and Economics

Thus: economics and finance are value-loaded, as at the most abstract level, our values are derived from our worldview.

Hence, this provides rationale for a distinct economic system. Since factors affecting worldviews differ, different worldviews exist leading to different 'systems' for different peoples:

- Foundations, operational principles, goals;
- Theories also differ;
- Islamic world view based on the Qur'an;
- Fundamental concepts in the Qur'an are not open for changes in meaning.

Islamic Moral Economy, hence, aims at creating a new system.



Defining Islamic Moral Economy

Islamic moral economy:

- part of religion, Islam;
- deals with production, consumption and distribution activities of human beings according to Islamic worldview;
- making economic and financial choices according to Islam;
- describes, analyses, prescribes.



Defining Islamic Moral Economy

Islamic Moral Economy, thus, is an “approach to, and process of, interpreting and solving the economic problems of human beings based on the values, norms, laws and institutions found in, and derived from the sources of Islam”.

Islamic finance is the institutional aspect of Islamic Moral Economy, as to finance the economic activity in an Islamic framework, there is a need to have institutions using instruments according to rules and regulations, which are all bound by the Shari’ah.



Foundational Axioms-Philosophical Foundations

The leading Islamic economists and moralists have developed an axiomatic approach to the conceptual foundations of Islamic Moral Economy by treating Islamic ethos as an ideal through which economic and social policies dealing with every aspect of human life, including economic life, are assessed.

In this approach Islam is seen as a system of ethics. The philosophical and conceptual foundations of this system are as follows:



Foundational Axioms-Philosophical Foundations

i. Tawhid (God's unity and sovereignty).

The Islamic worldview is based on *tawhid* (the Oneness of God), *risalah* (God's prophets as the source of Divine Guidance), *akhirah* (life-after death, that is the continuity of life beyond death and a system of accountability based on Divine Law).

This axiom indicates the vertical dimension of the ethical system. It provides for freedom of action whereby each individual is viewed as an integral part of the whole.



Foundational Axioms-Philosophical Foundations

ii. 'Al-'adl wa'l-ihsan (Equilibrium and Beneficence - Socio-Economic Justice)

Individuals are expected to establish justice (*'adl*) and promote beneficence (*ihsan*), resulting in attaining high levels of good life (*hayat al-tayyebah*), both individual and collective.

This axiom provides for the horizontal dimension of equity leaving a lot of freedom for policy details, as, for example, striking an appropriate balance between the needs of present and future generations:

- Need fulfilment;
- Respectable source of living;
- Equitable distribution of income and wealth;
- Growth and stability.



Foundational Axioms-Philosophical Foundations

iii. *Ikhtiyar* (Free-will)

Although individual freedom is guided by broad guidelines, and individuals may travel their own paths, careful intellection is required “to interpret-reinterpret that freedom within specific societal contexts, and to suit the needs of changing times”.

iv. *Fard* (Responsibility)

This axiom states that although ‘responsibility’ is voluntary, individuals and society need to conserve for the public good. Hence, there is a social aspect of every asset owned or managed by private or public entities.



Foundational Axioms-Philosophical Foundations

v. *Rububiyyah* (Divine arrangements for nourishment, sustenance and directing things towards their perfection)

This is the fundamental law of the universe, which throws lights on the divine model for the useful development of resources and their mutual support and sharing. It is in the context of these divine arrangements that human efforts take place.

vi. *Tazkiyah* (Purification plus growth)

The mission of all the prophets of God was to perform the *tazkiyah* of individual in all his/her relationships with God, with other fellow individuals, with the natural environment and with society and the state. Hence, growing in harmony.



Foundational Axioms-Philosophical Foundations

vii. *Khilafah* and human accountability before God (Individual's role as God's vicegerent on earth)

This defines human being's status and role, specifying the responsibilities of individual as such, of a Muslim and of the Muslim *Ummah* as the repository of this *khilafah*. From this follows the unique Islamic concept of individual's trusteeship, moral, political and economic, and the principles of social organisation.

Thus, the implications of *Khilafah* are:

- Universal solidarity;
- Resources are trust from God;
- Humble life-style;
- Human freedom;



Foundational Axioms-Philosophical Foundations

vii. *Maqasid-al Shariah* (Objectives of the Shariah)

The objective of the *Shar'iah* (the Islamic way and code of conduct) are in the words of al-Ghazali (d. 505 AD) are:

“The obligation of the *Shari'ah* is to provide the well-being of all humankind, which lies in safeguarding their faith, their human self (*nafs*), their intellect (*'aql*), their progeny (*nasl*) and their wealth (*mal*).



Foundational Axioms-Philosophical Foundations

Consequently,

“The universal ethical system, based on these axioms, is believed to produce policies aimed at enhancing motivation to seek knowledge and work, enhance productivity, and enhance transparency in government. They should also enhance intra-and intergenerational equity” (Naqvi, 1994).

“The Islamic concept of economics and economic growth and development follows from its concept of *tazkiyah*” as it addresses itself to the problem of economic aspect of human life “in all its dimensions”; *tazkiyah* is “concerned with growth towards perfection through purification of attitudes and relationships. The result of *tazkiyah* is *falah*, prosperity in this world and the hereafter” (Ahmad, 1994: 20).



The Operational and Institutional Features of Islamic Economic System

I. The Islamic scheme for social change and regeneration of human societies is based on methodology that is different from conventional economic and political ideologies:

- **Social change** has to be motivated, planned and achieved through individual and collective effort;
- **People are active agents of change** through the vicegerency task assigned to him/her and through the accompanying free will given to him/her... All human, physical and institutional factors in the production, consumption and distribution of goods and services must be subject to his/her deliberate individual and social choices within the framework provided by Islam for the direction of conscious choice.
- **There needs to be change** not only in the environment, but also within the hearts and souls of men and women-their attitudes, motivation, and commitment, and their resolve to mobilize all that is within them and around them for the fulfilment of their objectives.
- **Life is a network of relationships**, and consequently change has to be balanced, gradual and evolutionary. Innovation is to be coupled with integration.



The Operational and Institutional Features of Islamic Economic System


2. Self-interest is a natural motivating force in all human life. But self-interest has to be linked to the overall concept of good and justice
3. Private property and private enterprise are affirmed as inalienable rights and a natural mode for economic activity.

But the very concept and function of property is transformed by the provision of moral and legal filters, and instilling in people's minds and hearts the notion that all in its forms -physical and human, machine power and brain power- property is a trust (*amanah*), and as such, property rights are subject to moral limits and used as a means of fulfilling ethical objectives - the *Maqaasid al-Shari'ah* (the objective of the Islamic way).



The Operational and Institutional Features of Islamic Economic System


4. Economic efforts take place through the process of cooperation and competition.
 - The market mechanism is the natural corollary of private property, freedom of enterprise and motivation for profit and reward.
 - Scriptural guidance and historical evidence establish that trade, the promotion of production and the exchange of goods and services, the pursuit of genuine profit, protection of the market mechanism, and a legal framework for the fulfilment of contracts, are pillars of the Islamic economic system.
 - Effort, innovation, creativity, division of labour, technology and skills development have been emphasised by all major Muslim thinkers along with cooperation, compassion, justice, charity and solidarity.



The Operational and Institutional Features of Islamic Economic System

5. The market mechanism is a fundamental pillar of the Islamic economic scheme. But Islam demands actions by extra-market institutions to ensure that the market does not degenerate into wild capitalism, and that self-interest and the profit-motive do not create a situation that is socially disruptive and in violation of norms of justice and fair play.

- A moral filter at the level of personal motivation;
- Family as a social and economic unit to provide an initial system of social security and solidarity;
- Government should be able to provide regulative framework;
- A network of voluntary organisations (*waqf* system), third sector; charity is transformed by making part of it a legal obligation;
- Concern about the problem of waste, over-utilization and the excessive exploitation of non-renewable natural resources and the ecological and environmental aspects of moral activity (*Amanah and haq*);
- Consequently, distributive justice and social security have become structured elements of the Islamic economic system and not merely voluntary supplements.
- The prohibition of certain sources of income is a particularly distinctive element of the Islamic economic system, such as *riba* (usury/interest), gambling, speculation, fraud, exploitation and extortion. Islam lays down an elaborate code of business ethics to ensure honesty, transparency and equity in business and financial dealings.



The Operational and Institutional Features of Islamic Economic System

Consequently;

- Components, relationship and goals must be based on sources of Islam;
- Market: market in Islam must be a market which reflects the norms;
- Islamic values should determine consumer and producer behaviour;
- Elimination of extreme inequalities;
- Importance of redistributive schemes

Islamic moral economic system, on the one hand, aims to guarantee individual liberty, freedom of choice, private property and enterprise, the profit motive and possibilities of unlimited effort and reward.

On the other hand, it seeks to provide effective moral filters at different levels of life and activity and established institutions in the voluntary sector, as well as through state apparatus to ensure economic development and social justice in the society..



The Operational and Institutional Features of Islamic Economic System

Ibn Khaldun's (15th century)'s framework provides a summary of the interdisciplinary dynamic model for Islamic socio-economic system:

- "The strength of the sovereign (*al-mulk*) does not become consumed except by implementation of the *Shari'ah*;
- The *Shari'ah* cannot be implemented except by a sovereign (*al-mulk*);
- The sovereign cannot gain strength except through the people (*al-rijal*);
- The people cannot be sustained except by wealth (*al-mal*);
- Wealth cannot be acquired except through development (*al-'imarah*);
- Development cannot be attained except through justice (*al-'adl*);
- Justice is the criterion (*al-mizan*) by which God will evaluate humanbeings; and
- The sovereign is charged with the responsibility of actualising justice".

(Chapra, 2000: 147-8)



Methodology of Islamic Moral Economy

The methodological postulates of Islamic Moral Economy, on the other hand, can be summarised as follows:

- *Sociotropic individual*, not only individualism but social concern is a prerequisite;
- Behavioural postulates: socially concerned God-conscious individuals who
 - (a) in seeking their interests concern with the social good,
 - (b) conducting economic activity in a rational way in accordance with the Islamic constraints regarding social environment and hereafter; and
 - (c) in trying to maximise his/her utility seek to maximise social welfare as well by taking into account the hereafter as well.



Methodology of Islamic Moral Economy

• *Market exchange* is the main feature of economic operation of the Islamic system; however, this system is filtered through an Islamic process to produce a socially concerned environmentally friendly system. In this process, socialist and welfare state oriented frameworks are avoided not to curb incentives in the economy.

Hence, *two dimensional utility function* (present and the hereafter), which leads to *homolamicus*, or as Arif (1989: 92-94) names 'Tab'ay' (obedient) human-being. "To be a Muslim is a necessary but not a sufficient condition to be a *Tab'ay*" (Arif, 1989: 91). As to be qualified as a *tab'ay*, one needs to operationalise Islamic principles in every aspects of her/his life.



Mechanisms and Instruments of Islamic Moral Economy System

Islamic economic and financial activities are shaped by there kinds of measures:

- Positive Measures (zakah, hisbah);
- Voluntary measures (sadaqha, awqaf);
- Prohibitive measures (riba);

Islamic Institutions and Instruments:

- Elimination of *riba*;
- Islamic financial system;
- *Hisbah* for market regulation system
- *Zakah*;
- *Takaful*;
- *Awqaf* system



Reflections: System Understanding

- Islamic Moral Economy aimed at creating a world order with distinct system of economics.
- In this identity politics, the Islamic version of the modern institutions and behavioural norms such as the *homolamicus* or *tabaa'ya* individual are sought for.
- In other words, Islamic Moral Economy with the conceptualisation of *homolamicus* proposed a normative world or the utopia, which states “what people should strive towards, as opposed to how people are likely to behave (the ‘ought’ as opposed to the ‘is’)”.
- However, this is related to systemic aspirations with the value system expressed in identity politics.



Reflections: System Understanding

- This has consequences for Islamic finance, which is the operational tool of Islamic Moral Economy, as Islamic finance, in the aspirational sense aims to operationalise and fulfil the economic systems of Islam.
- Despite such a system understanding, a critical approach to the development of Islamic finance, however, indicates a very pragmatist development.
- Since the systemic understanding of Islamic Moral Economy could not be achieved, Islamic finance has developed its own working framework in a very pragmatist manner, as it has ended up being located within the neo-classical paradigm.




From Utopia to Reality: Islamic Finance as a Hybrid Financial System

- In this alternative system understanding Islamic finance and banking, was assigned an important role: economic development with the objective of human well-being and social justice.
- The initial experience of Islamic finance and banking in Egypt and Malaysia had such objectives, as they were socially oriented institutions.
- In particular since the 1990s, while the operations of Islamic finance and the nature of Islamic modes of financing have expanded, the lives of individuals have not been touched upon by this enormous growth.




From Utopia to Reality: Islamic Finance as a Hybrid Financial System

- The close scrutiny of Islamic financing indicates that the social dimension is limited with their *zakah* and other charitable activities, which does not imply any systematic economic development and social justice programme aiming at capacity building.
- Also poor CSR scores, as there is no proactive dynamic understanding of social responsibility is the prevailing attitudes amongst the IBFI.
- Indeed, it can be seen that Islamic banks and financial institutions have opted profitable Islamic financing such as *murabahah* instead of *musharakah* and *mudaraha* (PLS and participatory) for instance. This is important as this indicates that difference in the orientation of Islamic finance.



From Utopia to Reality: Islamic Finance as a Hybrid Financial System

- Taking into account that Islamic Moral Economy aims that Islamic finance should be equity financing towards a particular value-added creating economic activity, the change in the directions of Islamic finance is rather meaningful. **From PLS and participatory financing to efficiency and profit maximisation (*murabahah* centred financial transactions); namely from asset based financing to debt-based financing (see also *tawarruq*).**
- Considering also that Islamic Moral Economy aims at economic development this can only be achieved with long-term financing. However, evidence shows that “Islamic banks rarely offer long-term financing to entrepreneurs seeking capital”.
- In addition, developmentalist financing with the objective of economic growth necessitates financing sectors such as agriculture, industry, and manufacturing. However, “the majority of Islamic banks’ financial transactions at least initially were directed away from agriculture and industry and toward retail or trade financing”.
- In relation to social lending, it is at an negligible level in IBFs.



From Utopia to Reality: Islamic Finance as a Hybrid Financial System

- In sum, regarding the utopia and realities of Islamic Moral Economy and finance, “the gap between promise [Islamic Moral Economy] and performance [Islamic finance] was greatest in the area of economic development. Despite support and special privileges ... obtained by Islamic banks, they behaved like risk-averse agents. The early goal of concentrating on profit-and-loss sharing was soon abandoned. The objective of penetrating the hinterland and serving the rural areas was not fulfilled” (Warde, 2000: 175).



From Utopia to Reality: Islamic Finance as a Hybrid Financial System

- The realities of financial markets which prioritise **economic incentives rather than religious behavioural norms** has forced the Islamic finance to become part of the international financial system, in which it is recognised as heterogenoisation of financial products deprived of their value system.
- Since the 1990s, therefore, Islamic finance represents hybrid financial products of the international financial system.
- Thus, the difference has been reduced to legal technicality, and the value system is no longer mentioned beyond describing the prohibition of *riba* in quotation verses from the *Qur'an*; as the consequentialism is not taken into account.



From Utopia to Reality: Islamic Finance as a Hybrid Financial System- Reasons

- The realism of this constructivist ideology is tested with the developments which have taken place in Islamic finance, which has given up the value system, identity politics and systemic understanding of Islamic Moral Economy and has become part of the international financial system, which has been criticised by Islamic economists for its failure for economic development in the Muslim world and also for being materialistic.
- Islamic finance, hence, in its deviation from the norms and axioms of Islamic Moral Economy followed a **realistic attitude based on positivism rather than normativeness**; and hence has given up the utopia imposed on or assigned to itself by Islamic Moral Economy.



From Utopia to Reality: Islamic Finance as a Hybrid Financial System- Reasons

- Indeed, this epistemological difference is related to the modern interpretation of the *Qur'anic* verses and Islamic injunctions.
- The pragmatist position of Islamic finance as opposed to the foundational and aspirational position of Islamic Moral Economy is based on the notion that “the revealed word of God in the *Qur'an* itself embodies rational economic principles that are quite in line with the modern assumptions of neoclassical economic theory. As a form of universally applicable theory **about human beings' economic behaviour**, economic theory necessarily is in accord with and confirms the source of universal knowledge, the *Qur'an*: *homo Islamicus* and *homo economicus* are one and the same”.
- On the contrary, Islamic Moral Economy's reading of the same *Shari'ah* rules emphasize social justice, need fulfilment and redistribution, namely a socio-political reading within a political economy framework.



From Utopia to Reality: Islamic Finance as a Hybrid Financial System- Reasons

- In conclusion, with Islamic finance we are yet again in the beginning of the vicious circle, due to the Islamic banks' lending criteria, terms and costs of loans, financial exclusion from personal banking remains an issue. Importantly, due to the same reasons entrepreneurs who have been excluded from conventional banking are also excluded from the use of Islamic finance.
- The existence and prevalence of such developmentalist issues negates the entire discourse of Islamic Moral Economy and finance in relation to social justice or *maslahah*.



Testing the Assigned Values of Islamic Finance

- Community banking: Serving communities, not markets;
- Responsible Finance, as it builds systematic checks on financial providers; and restrains consumer indebtedness; ethical investment, and CSR Initiatives;
- Alternative Paradigm in terms of stability from linking financial services to the productive, real economy; and also it provides moral compass for capitalism;
- Fulfils Aspirations in the sense it widens ownership base of society, and offers ‘success with authenticity’.



Testing the Assigned Values of Islamic Finance

- Regarding the first objective of community banking, the real life experience shows that Islamic finance has not done much to contribute to capacity building in the communities.

On the contrary, Islamic banking and finance has aimed at becoming part of the international markets, despite the imposed social identity “Islamic banks are quick to point out that they are not charitable organizations, and that they must turn a profit”.



Testing the Assigned Values of Islamic Finance

- Regarding responsible finance, there is not a universally accepted regulatory body, which can systematically check on financial providers. The initiatives by AAOIFI and IFSB remain weak and are not generally accepted.

As part of restraining consumer indebtedness, the data indicates that IBF institutions prefer transactions, which are debt financing oriented, as they are more profitable. Thus, this claim is not fulfilled either.



Testing the Assigned Values of Islamic Finance

- In relation to ethical investment, restraining the investment areas of Islamic finance does not necessarily make Islamic finance ethical, but only implies that Islamic finance fulfils the legal expectations as the screening of Islamic investment is part of the *Shari'ah*, which makes Islamic finance only 'active' in the CSR framework.

However, considering that ethicality refers to be 'pro-active' in the case of IBFs, there is not much indication that IBFs are ethical as such. This again refers to CSR initiatives, as recent studies on CSR of IBF demonstrate that they have not pro-actively developed such an understanding and their perceptions of CSR remains within the framework of *zakah* distribution and other non systemic charitable activities (Sarially, 2005).



Testing the Assigned Values of Islamic Finance

- As an alternative paradigm, Islamic finance is no longer part of the Islamic Moral Economy system understanding, and therefore does not have macroeconomic consequences.

In addition, claiming that it links financial services to the productive side of the economy is not convincing either taking into account that the most preferred financing is debt financing as opposed to the original expectations that it would be equity financing undermines this claim too.



Testing the Assigned Values of Islamic Finance

- Furthermore, becoming part of the international financial system through hybridisation, it is difficult to state that Islamic finance plays the role of a moral compass for capitalism. On the contrary, it seems that Islamic finance has much to learn from conventional finance in terms of ethical and CSR financing issues.



Testing the Assigned Values of Islamic Finance

- As regards to fulfilling aspirations, Islamic finance has not affected the social capacity building, and therefore has not been involved in widening ownership, which could have been possible through venture capital or profit-loss sharing type of investments.

While referring to the *Qur'an* and locating the principles governing Islamic finance in *Qur'an* refers to authenticity, consequences of Islamic finance do not show success in the intended meaning of this authenticity or *Shari'ah* as located in the aspirational notions of Islamic Moral Economy.

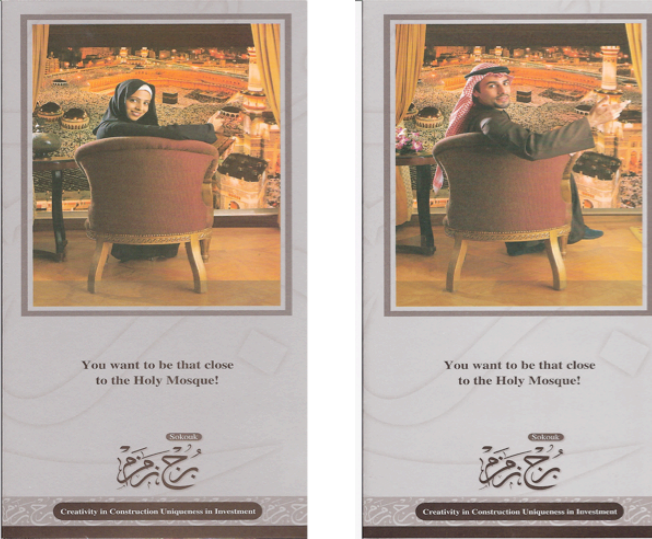


Testing the Assigned Values of Islamic Finance

Results:

- Community banking: Serving communities, not markets: **Position: X**
- Responsible Finance, as it builds systematic checks on financial providers; and restrains consumer indebtedness; ethical investment, and CSR Initiatives: **Position: X**
- Alternative Paradigm in terms of stability from linking financial services to the productive, real economy; and also it provides moral compass for capitalism: **Position: X**
- Fulfils Aspirations in the sense it widens ownership base of society, and offers 'success with authenticity': **Position: X**

An Example in the Failure of Islamic Financing



You want to be that close to the Holy Mosque!

You want to be that close to the Holy Mosque!

Zamzam Towers right before Kabah in Makkah financed through Islamic Finance. Even the advertisement indicates that the project is not socially and religiously right; as it undermines equal opportunity in this most holy place; undermines the spirituality of the place; undermines the historicity and environment

Creativity in Construction Uniqueness in Investment

Creativity in Construction Uniqueness in Investment

Second Best Solution

- The developments in Islamic Moral Economy and finance indicate that Islamic Moral Economy can be considered as the 'first best solution' by borrowing the conceptual understanding from neo-classical economics.
- In this 'first best solution', like conventional economics' aiming of creating *homoeconomicus*, Islamic Moral Economy aimed at creating *homoislamicus* by introducing and changing the behavioural norms of individuals for this project.
- Therefore, its aspirational project supported by behavioural and philosophical norms should be considered as the first best solution.




Second Best Solution

- Similar to conventional economics where the first best solution failed to work, it is clear that the Islamic first best solution cannot be attainable either.
- The research indicates that Islamic banks aim at efficiency by ignoring and relegating the importance of social efficiency. Thus, in the trade off between economic and financial efficiency and social efficiency, the choice has been economic and financial efficiency.
- This result is an indication of the overwhelming power of *homoeconomicus* behavioural norms over *homoislamicus*.




Second Best Solution:

- Recalling that the first best solution is not held in conventional economics, and therefore, neo-classical economics offered the second best solution to the failure of the market economy by offering rationale and certain institutions to curb the excesses of this failure, the same analogy can be offered to the current state of IBF institutions and the consequences of their working mechanism.
- The second best state is the current nature of Islamic banks and financial institutions.



Second Best Solution:

- In this second best solution, Islamic banks are not expected to conduct social justice oriented activities beyond what they are legally expected and also they are not expected to fulfil the ethical norms, hence, to move beyond their legalistic requirements in relations to social issues.
- However, the important question is now how the social justice is to be served? What social-financial institutions Islamic finance can offer to solve economic development issues in the developing Muslim world?



Second Best Solution:

- Social justice remains to be an important discourse of Islam and the prophetic tradition. Therefore, the search for fulfilling social justice should continue.
- Looking at the institutions of Islamic Moral Economy to overcome the economic underdevelopment issues, it does not provide much hope to directly tackle the development needs.



Second Best Solution:

- I do not suggest that IBFs should be restructured to incorporate the authentic appeal to the ethics and social justice.
- On the contrary, they should be perceived as part of the second best solution, which could not achieve the framework provided by the Islamic economic system understanding. Hence, Islamic commercial banks.
- IBFs, therefore, should remain to respond to the market as it is, as “the current Islamic experience, notwithstanding its limitations, has proved to offer an invaluable service for both consumer and producer needs and it may well remain for this particular purpose” (Tag El-Din, 2004).



Second Best Solution:

- However, the social justice and developmentalist purpose including long-term financing and venture capital can be structured in “more specialized Islamic institutional set up ... in line with the recent global developments where a broad variety of institutional structures” (Tag El-Din, 2004) exists as examples.



Overcoming the Failure: (Islamic) Social Banking as a Way Forward

- Accepting that the current state of Islamic finance as the second best state requires new models of development.
- The need to moderate the consequences of the failure of Islamic finance or the second best solution is important.
- In this moderating function, new institutions should be created as a new project for ethical Islamic finance beyond IBFs, as the latter remains loyal to legalistic dimensions of Islamic but not Islamic ethics.



Overcoming the Failure: (Islamic) Social Banking as a Way Forward

- In this new modelling or reorienting “the brand name of Islamic finance [should] emphasize issues of community banking, microfinance, socially responsible investment, and the like” (El-Gamal, 2006: xii).
- Creation of ethical Islamic finance and investment institutions in the form of Islamic social banking as part of the civil society and also creation of social banks should be considered as the next stage of financial development aimed at social capacity building and individual functioning as defined by Sen (1999).



Overcoming the Failure: (Islamic) Social Banking as a Way Forward

- This probably is not something entirely novel; as the very first experience in Egypt was a social bank. Thus, in this new stage equity based finance with direct involvement of civil society should be the solution.
- Such an institutional solution aiming at correcting and moderating the consequences of Islamic finance will contribute to the development of individual lives by focusing on micro dynamics of the society rather than aiming at affecting the financial equilibrium.
- This fits into the new development paradigm as well; which has shifted the focus from macroeconomic development to micro dynamics.



Overcoming the Failure: (Islamic) Social Banking as a Way Forward

- Social banks in its modern form are practised in many European countries in order to provide ethical financing but at the same time to work towards micro development purposes, because it is a way forward to overcome banking exclusion but at the same time aims to expand the ownership base of the society.
- Reifner (2001: 198) social banking: “a socially responsible form of banking in which suppliers of financial services have a vested interest in the social outcome and effects of the distribution of their products”.
- Also, social banks internalises the moral dimensions of the market system “to introduce ‘need orientation’ (Amartya Sen) into the exchange of commodities and services to further the general welfare” (Reifner, 2001: 199) of the society.



Overcoming the Failure: (Islamic) Social Banking as a Way Forward

- The examination of the markets and examples of needs, show the great similarity between aspirational IBF and social banking. Therefore, adopting social banking to Islamic finance understanding should not be a difficult exercise in terms of objectives.
- Examining the nature of social banks further substantiates the claim that social banking can be considered as the new phase of Islamic finance with *maslahah* objectives.



Overcoming the Failure: (Islamic) Social Banking as a Way Forward

The social banks, as the post-war European experience demonstrates, does not only include “traditional core bodies of the social economy, mutuals, co-operatives and associations, but also new organisational models which fit neither the classical public or private sector forms” (Mayo and Guene, 2001: 5), as they:

- try to find solutions rather than to place themselves in a new market sector;
- often refer to factors as social solidarity, democratic organisations or the primacy of the individual over capital;
- are often the results of public/private partnership and have a close relationships with their local communities;
- do not have the market as their sole source of income instead securing public subsidies, donations or loans - they often have very mixed income;
- often give specific attention to disadvantaged people;
- have small scale structures with larger numbers of non-active associates of unpaid volunteers.




Overcoming the Failure: (Islamic) Social Banking as a Way Forward

- In checking the extent to which social banks complement Islamic banks, it is clear that *maslahah* provides the moral standard for social good, and *Shari'ah* requires justice and benevolence.
- Therefore, development of consciousness on the side of the banks about the consequence of their business beyond narrow *Shari'ah* compliancy into pro-active thinking should be satisfactory enough for IBFs to establish subsidiaries or new social banks to practise social banking.




Overcoming the Failure: (Islamic) Social Banking as a Way Forward

- In reorienting towards social banking, “the ‘Islamic’ in ‘Islamic finance’ should relate to the social and economic ends of financial transactions, rather than the contract mechanics through which financial ends are achieved’ (El-Gamal, 2006: xiii). Thus, as Siddiqi (2004) argues a move towards goals and policy rather mechanistic and legal structure of Islamic finance will serve the human well-being much better.



Conclusion

- Correcting the failure of Islamic finance, which has deviated from the aims of Islamic Moral Economy by giving way to the economic incentives, should be in the form of introducing further but robust social justice oriented principles into Islamic finance by endogenising social justice into its operational nature as in the example of social banks.
- Therefore, there is a need to go beyond the legal interpretations and reading of the text; as value and objective oriented approach would help to overcome the growing tension between the performance of Islamic finance and the utopia of Islamic Moral Economy.



Conclusion

- By using the analogy of the neo-classical theory, IBFIs have to move into the third stage of institutional development by introducing social banking into the market.
- This is the objective of Islamic economic system also: to create an equilibrium between the scarce resources and unlimited needs through a moral filter system by producing a socially and financially optimal state of the economy in which human well-being is served through inclusive policies and value-added creation oriented economic activity (Chapra, 2000).

Considering the Dichotomy between the
Ideals and Realities of Islamic Finance



For socially and environmentally
responsible value oriented just economic
and financial system, which can enable
individuals to function and which can aim
at well-beings of individuals...

*Utopias should exist so that
realities can be constructed and
engineered..*

Thank you..