



**CONCEPTUALISATION OF THE SECOND BEST
SOLUTION IN OVERCOMING THE SOCIAL FAILURE OF
ISLAMIC BANKING AND FINANCE: EXAMINING THE
OVERPOWERING OF *HOMOISLAMICUS* BY
*HOMOECONOMICUS***

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ABSTRACT

The phenomenal growth of the Islamic banking and finance (IBF) industry has been remarkable since it came into existence just over thirty years ago. However, a closer reading of this positive development indicates that the IBF industry does not necessarily share the aspirations of Islamic economics, which aims at creating a world order in which the moral economy of Islam with its authentic value system can exist. In other words, the Islamic economic system aspires for the development of Islamic economics and financial institutions founded upon *homoislamicus*, agents concerned about social justice and human-centred economic growth and development. This indeed indicates the divergence between the aspiration of Islamic economics and the world of IBF. After highlighting and analysing the tension areas between the two and the reasons and sources of this apparent divergence, this paper argues that IBF needs to move into its third stage of development through the institutionalisation of social banking as a second best solution in overcoming the social failure of IBF and in creating value-added for capacity building and social justice.

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1. INTRODUCTION

The recent unprecedented growth in Islamic banking and finance (IBF) vindicates the aspirations of both the founding fathers of Islamic economics and Muslims all over the world. However, a critical analysis of IBF institutions' phenomenal growth indicates a contradictory development. Namely, that Islamic finance, currently, does not seem to share the foundational claims of Islamic economics. While developments in the discourse of Islamic economics have been weak due to underdeveloped intellectual capital and lack of research interest, the emerging wealth in the Muslim world, particularly in the Gulf region forced IBF to develop beyond the framework of Islamic economics, which resulted in weaker developments in its practical discourse.

To be more precise, Islamic economic theory has developed coherent foundational axioms without the operational axioms through which IBF institutions can function. In response, IBF has implicitly adopted neo-classical assumptions. In other words, IBF, with a pragmatist attitude, adheres to the precepts of a neo-classical paradigm of managing wealth that conflicts with the foundational axioms upon which an Islamo-ethical financial system was intended to be built. Granted, certain tendencies of neo-classical economics are found in the pioneering writings of Islamic economics, however, these are mostly related to policy suggestions rather than axioms or methodology. This contradictory tendency in contemporary IBF can be observed in its eclectic methodological framework, which, due to its neo-classical nature, ignores the intrinsic social-welfare emphasis in Islamic economics that emphasizes both individual self-maximisation and maximisation of societal well being.

Hence, IBF does not support nor is it supported by the normative assumptions of Islamic economics. Consequently, the pragmatic approach adopted by IBF plays an important role in the internationalisation of capitalism throughout the Muslim world. In the Western world, the emergence of social responsibility, ethical finance and business practices has constrained extremes of capitalist hegemony. However, in the Muslim world, capitalism, in its most primitive and inconsiderate form is thriving, despite the fact that Islamic economics provides foundational axioms that proposes an ethical system of economics and finance based on the ontological and epistemological sources of Islam.

Without premising Islamic finance on the normative value-principles of Islamic economics, IBF is reduced to the mere removal of *ribā* (interest) and conducting financial activity in contractual norms derived from the *sharāh*. Rather than being part of the Islamic political economy, IBF has been pursuing policies away from the theoretical underpinnings and systemic understanding of Islamic economics and has located a surrogate financial framework in neo-classical economics. This trend has troubled the founding fathers of modern Islamic economics. Thus, “a distinctive feature of the recent discussions on Islamic banking has been the growing wedge between its conventional theory and current practice” (Hasan, 2005).

This paper, thus, aims to highlight the tension areas between Islamic economics and IBF, by particularly making reference to its participants, namely, *homoislamicus* and *homoeconomicus* through normative assumptions. More clearly, it will focus on each participant’s institutions, constructs of their respective political economies in regards to their normative principles and the outcomes of both paradigms. Therefore, to accomplish this objective, this paper pursues discourse analysis as a methodology, through which it aims to highlight how each of these two paradigms are being constructed. In other words, a political economy approach, with a methodology utilizing discourse analysis, is adopted to locate the manner in which Islamic economics and IBF have developed separate from each other in terms of divergent trends and paradigms. Consequently, the failure in developing an ethical financial system and, hence, developing ethical norms away from legal interpretations of the *sharāh* is to be discussed.

This paper suggests that Islamic economics has a great potential to create an ethical Islamic financial system that is not only relegated to the elimination of *ribā* or interest. However, this requires a concerted effort to creating a political economy approach or systemic paradigm. Therefore, this paper argues that the next step in the evolution of IBF should be social banking, in order to revive its initial purpose of social justice, poverty alleviation and prevention of exploitation.

2. ISLAMIC ECONOMICS: UTOPIA

Islamic economics, in its modern usage, came into existence in the early 1970s mainly as a critique of both the capitalist economic mode of development and communist resource allocation system. The pioneering figures opined that the failure of economic development in

Muslim society was capitalist economic development strategies that ignored the importance of societal well being. Consequently, their objective was to develop an economic system that would develop a human-centric development strategy.

While Kahf (2003) suggests that Islamic economics cannot be considered outside the main discipline of economics, that perspective ignores the primary aim of an Islamic economics paradigm with its own values, rules and institutions with its politically orientated 'systemic' understanding. The foundational axioms of the Islamic economic paradigm, then, operationalize the aspirations of Islamic economists in aiming at the creation of human-centric economics. Ahmad (1980, 1994, 2003), Ariff (1989), Chapra (1992 and 2002), El-Ghazali (1994), Naqvi (1981, 1994), Siddiqi (1981), and Sirageldin (2002) presented works that used, in varying degrees, an axiomatic approach to justify the existence of an Islamic political economy by treating Islamic ethos as an ideal through which social and economic policies are assessed. These axioms are as follows: *Tawûd* (unity), indicates the vertical dimension of the Islamic ethical system; *Al-'adl wa'l-iûsûn* (justice equilibrium) provides for the horizontal dimension of equity; *Ikhtiyûr* (free-will), provides individual opportunities in the economic system to choose between; *Fard* (responsibility) implies that individuals and society need to uphold public good; *Rububiyyah* indicates divine arrangements for nourishment, sustenance and directing things towards their perfection; *Tazkiyah* calls for growth with purification that should incorporate the good of others and be conducted with ethical and moral considerations; and *Khilafah*, which indicates an individual's role as God's vicegerent on earth. Lastly, the *maqûsid al-sharûah* (*objectives of the sharûah*), which is used to interpret the text and restore the principles of Islamic economics in relation to the objectives of the *sharûah* is interpreted to suggest that Islamic economic principles must lead to 'human well-being.'

Together, these axioms define the foundational principles and framework, in which economic and financial activity is intended to take place, incorporating intra-and inter-generational social justice. Moreover, it reveals itself in the methodological framework of the Islamic economic system. In comparing the methodologies of Islamic economics and conventional economics, the points of contrast are unambiguously understood. To highlight those points of contrast, first the methodological framework of neo-classical economics is summarised as follows:

- (i) The point of departure is *methodological individualism*.
- (ii) Behavioural postulate: *self-interest oriented individuals* who (a) seek their own interests, (b) in a rational way, and (c) try to maximise his/her own utility;
- (iii) *Market exchange*.

Hence, a conventional economic system is based on a *one dimensional utility function*, which leads to *homoeconomicus* or the economic individual in a market system. The methodological postulates of Islamic economics, on the other hand, can be summarised as follows (Asutay, 2007):

- (i) *Socio-tropic individual*, not only individualism but social concern is a prerequisite;
- (ii) Behavioural postulates: socially concerned God-conscious individuals who (a) in seeking their interests are similarly concerned 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 seeks to maximise social welfare as well by taking into account the hereafter.
- (iii) *Market exchange* is the main feature of economic operations in the Islamic system; however, this system is filtered through an Islamic process to produce a socially concerned and environmentally friendly system. In this process, socialist and welfare state oriented frameworks are avoided to prevent curbing of incentives in the economy.

Hence, in Islamic economics we have the *two-dimensional utility function* (present and the hereafter), which leads to *homoislamicus*, or as Arif (1989) names it, *tab'ay* (obedient) human-being, where "to be a Muslim is a necessary but not a sufficient condition to be *tab'ay*" (Arif, 1989). Hence, as an implication, to be qualified as *tab'ay*, one needs to operationalise Islamic principles in every aspect of one's life.

Therefore, Islamic economics aims at a world order where the ontological and epistemological sources, the Qur'ān and Hadīth, determine the framework of the economic value system; its foundational and operational dimensions and the behavioural norms of individual Muslims. Islamic economics, thus, is an "approach to [and process of,] interpreting and solving the man's economic problems based on the

values, norms, laws and institutions found in, and derived from all sources of knowledge [in Islam]” (Haneef, 2005). This, however, implies both a systemic understanding and a political dimension. Recalling that modern Islamic economics emerged as part of the Islamic resurgence in the 1970s, with political aspirations involving constructivist identity politics, it is understandable that it was perceived to be a complementary political component. However, as in Foucault’s philosophy, power is central to define social and political meaning. Muslims, by not having such global power, were unable to establish their political and economic order.

This has consequences for IBF, which is an operational tool of Islamic economics. To reiterate, Islamic finance is an institutional aspect of Islamic economics which finances and regulates economic activity in an Islamic framework. Thus, there is a requirement for IBF institutions to operate and utilise instruments, rules and regulations of the *shar’ah*. IBF refers to these institutions that in the aspirational sense, aims to establish and operationalise the Islamic economic system. Since the systemic understanding of Islamic economics is not considered by IBF (the reasons of which is discussed in a later section), IBF has developed a working framework located in the neo-classical economic paradigm.

3. FROM UTOPIA TO REALITY: ISLAMIC FINANCE AS A HYBRID FINANCIAL SYSTEM

Responding to the failure of capitalist and socialist economic development, the creation of IBF was inaugurated with the hope of providing a financial base through which economic development could be achieved. In its alternative system understanding, IBF was assigned an important role: economic development with the objective of human well-being and social justice. The initial experience of Islamic banking in Egypt in the late 1960s and early 1970s, for instance, had such objectives, as they were socially oriented institutions.

IBF, however, has become internationalised with significant petrodollar assistance since the 1980s. In addition, the 1990s has witnessed an unprecedented growth of IBF institutions and their assets base. Yet, upon closer scrutiny of their financing, it is clear that the social dimension is limited to *zakah* and other charitable activities, which, nonetheless, ignores systematic economic development and social justice action. While the operations of IBF and the nature of Islamic modes of

financing have expanded, the lives of common Muslim individuals have not significantly benefited from it.

It can be seen that IBF institutions have opted for profitable Islamic financing such as *murābaūah* instead of *mushārakah* and *muērabah*. This is important as it indicates the theoretical difference in orientation of IBF. More clearly, *mushārakah* and *muērabah* is equity-finance oriented, while *murābaūah* is debt-financing. Taking into account that Islamic economics aims for IBF to be preferably equity financing towards value-added creating economic activity, the change towards debt-financing is rather paradoxical. To support this, Iqbal and Molyneux (2005: 29) demonstrate, sampling from ten Islamic banks between 1994-1996, that the percentage weight of *mushārakah* and *muērabah* in the total activities was only 7% each, with *murābaūah* claiming 70% of the total financing. Therefore, “most of the financing provided by Islamic banks does not conform to the principle of profit-and-loss sharing. Instead, much of the financing provided by Islamic banks takes the form of debt-like instruments” (Aggarwal and Yousef, 2000). In addition, Hasan (2007), provides more recent data while studying the Malaysian case, according to which the percentage share of *mushārakah* declined from 1.4% in 2000 to 0.2% in 2006. Evidently, he shows that the major modes of Islamic financing are in the form of *bay‘ bithaman ‘ajil* and *ij‘arah thumma al-bay‘* with 55.9% and 25.2% respectively in 2006. In a more comprehensive manner, Nagaoka (2007) provides a time-series comparison focusing on the mode of financing for Bank Islam Malaysia Berhad (BIMB) and Dubai Islamic Bank (DIB). According to his calculations, on the average, from 1984 to 2006, *murābaūah* constituted 88.1% of the mode of financing for the former, and 67.3% for the latter. For the same periods, *muērabah* and *mushārakah* claimed, on the average, about 1.7% for BIMB and 9.3% for DIB. Hence, considering that in Islamic economics, equity or profit sharing financing is considered superior to debt-like financial instruments, having IBF institutions focusing more on debt-like financing is an indication that IBF institutions have deviated from the aspirational stand of Islamic economics.

In this context, it is important to reiterate that Islamic economics aims at economic development in a larger sense, which can be achievable only with long-term financing. However, evidence provided by Aggarwal and Yousef (2000), Iqbal and Molyneux (2005), Hasan (2007) and Nagaoka (2007) show that “Islamic banks rarely offer long-term financing to entrepreneurs seeking capital” (Aggarwal and Yousef,

2000). Moreover, developmental 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” (Aggarwal and Yousef, 2000: 94). That calculation is based on twenty-two Islamic banks from various countries, which reveals that “on average, 56.7 percent of financing by nominal value were for maturities lasting less than a year. Medium-term (one to two years) and long-term (two to five years) financing averaged 0.7 percent and 1.9 percent, respectively” (Aggarwal and Yousef, 2000: 103). Such evidence can also be found in Ahmed (2005), who, by using the case study of Sudan, suggests that after the initial years, Islamic banks moved away from financing agriculture and industry using profit-loss sharing schemes due to various reasons including moral hazard or imperfect information. Furthermore, Warde (2000: 175) states that “not only were Islamic banks less likely to invest in industry or agriculture, but they were more likely to invest their money abroad and to keep it in a foreign country.” As a result, the value added of IBFs to the local economy further declines, and the contribution of IBFs for economic growth of the real economy is rather elusive.

Since debt-financing is short-term oriented while equity financing is generally longer term and thereby, contributing more to economic development, the avoidance of equity financing in contemporary Islamic finance clearly indicates that IBF is not particularly interested in economic development and social welfare. Similarly, such concerns were raised by Choudhury (2001) who even criticises *mushārakah* and *muʿārabah* type of equity financing due to their failure in internalising socio-economic justice and the value of work. Consequently, he is of the opinion that to “transform these financial instruments to realise the ameliorative goals of *sharīʿah*, extensively cooperative participation must be explicitly introduced. Such rules must reflect the organisational and management processes involved in such extensively co-operative and co-ordinated participatory enterprises” (Choudhury, 2001). In addition, Warde (2000) is concerned with the utopia and realities of Islamic economics and finance, and therefore states that “the gap between promise [Islamic economics] and performance [Islamic finance] was greatest in the area of economic development. Despite their 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).

In relation to social lending, the percentage of *al-qarè al-hasan* is at a negligible level in the IBF sector (Aggarwal and Yousef, 2000). In addition, further involvement of the IBF sector in debt-like financing, including *tawarruq* issues, clearly undermines the ‘productive economic activity’ discourse in Islamic economics. The realities of financial markets, which prioritise economic incentives rather than religious behavioural norms, thus, has forced IBF to become part of the international financial system by adopting the commercial banking model. In that predicament, IBF is described as heterogeneous financial products deprived of their value system that is imposed by utopian Islamic economics. In other words, since the 1990s, IBF represents hybrid financial products in the international financial system and it is accepted that this particular hybridisation requires religious not secular construction. Thus, the difference has been reduced to a technicality in which the value system is referred to only in describing the Qur’anic prohibition of *ribè*.

It is important to understand the reasons of this divergence between IBF and Islamic economics. As mentioned previously, Islamic economics aims at creating a world order with political aspirations, namely a system (Asutay, 2007). In this identity politics, the Islamic version of modern institutions and behavioural norms, such as the *homoIslamicus* or *taba’ay* individual, are sought after. However, this is related to systemic aspirations and the value system expressed in identity politics. The realism of this constructivist ideology is tested by recent developments in IBF that has renounced the value system, identity politics and systemic understanding of Islamic economics. Consequently, IBF, by renouncing its own value-system, has become part of the international financial system, which has been criticised by Islamic economists for its materialism and failure in contributing meaningfully to economic development. In its essence, Islamic economics, with its conceptualisation of *homoIslamicus*, proposes a normative world or utopia, in which emphasis is on “what people should strive towards, as opposed to how people are likely to behave (the ‘ought’ as opposed to the ‘is’)” (Warde, 2000). IBF, in its deviation from the norms and axioms of Islamic economics, followed a realistic attitude based on positivism rather than normative-ness. In other words, Islamic economics provides foundational axioms and principles but not

operational axioms through which, Islamic financing could function in an authentic manner. This creates the “disparity between the functional ends and the formalist means employed to reach them” (Hamaoudi, 2007). It is also important to reiterate the role of political power and the nature of world politics, which prohibited the development of an Islamic economic system that would, similarly, provide IBF the opportunity space it needs to follow a path of authenticity. As a result, IBF institutions and their leading philosophies have relaxed the conditions of the utopia assigned to it by Islamic economics.

It should also be noted that the microeconomics of financing is indeed important in explaining the shunning of IBF from project financing and *mushārakah* and *muʿārabah* type of PLS financing. In other words, the usual microeconomic concerns such as risk, moral hazard, and adverse selection etc. have been instrumental for IBF in their misguided quest to adopt the commercial banking model with the primary objective of profit maximisation and efficiency, as expected from any neo-classical economics oriented institution. The rise of this internal discrepancy, discussed in a later section, constitutes the most crucial failure of Islamic economics, namely the difficulty in changing the economic behavioural norms of individuals despite the foundational axioms derived from Qurʾān and Sunnah. This contradiction was highlighted by Kuran as early as 1983. In other words, conversion from *homo economics* into *homo Islamicus* has not been successfully achieved.

Reflecting on this theoretical divergence, it should be stated that it is related to modern interpretations of Qurʾānic verses and Islamic injunctions. More specifically, the current pragmatist position of IBF opposes the foundational and aspirational position of Islamic economics. Those foundational and aspirational premises rest on the belief that “the revealed word of God in the Qurʾān 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, i.e. the Qurʾān. Hence, *homo Islamicus* and *homo economicus* are one and the same” (Maurer, 2005). Also, Kahf’s argument (2003) rejects a systemic understanding of Islamic economics by establishing it on similar norms of human behaviour. This provides further evidence for the pragmatist positioning of IBF. With that understanding, Islamic finance emphasises interpretations of *sharʿah*,

which focus on rationality and formal equality. Hence, the ban on *riba* is perceived as a mechanism through which decisions are made within a rational economic framework with the objective of rendering optimality of the market mechanism (Maurer, 2005). On the contrary, Islamic economics' reading of the same *shari'ah* injunctions emphasize social justice, need fulfilment and redistribution, namely a socio-political reading within a political economy framework. The position of Islamic economics is, thus, the *moralist modelling methodology* (Tag El-Din, 2004). Overall, Islamic economics suggests a new paradigm, while IBF utilises the same Islamic foundation in placing itself in the existing conventional paradigm, because "like any other financial system, Islamic banking has to be viewed as evolving to meet modern requirements" (Ahmad, 2005).

In sum, IBF is beginning to perpetuate a vicious circle due to the Islamic banks' lending criteria, contractual terms and costs of financing. Particularly, financial exclusion from personal banking remains a contentious issue. Paralleling personal banking, entrepreneurs excluded from conventional banking are, also, excluded from the use of IBF. Thus, the need of those entrepreneurs who cannot provide collateral is not met in the IBF sector. Clearly, the existence and prevalence of such developmental issues negate the entire discourse of Islamic economics and finance in relation to social justice or *ma'shlahah*.

4. TESTING THE ASSIGNED VALUES OF ISLAMIC FINANCE

As opposed to the concerns of certain academics, practitioners suggest IBF aims to uphold the following values among others (Khan, 2007):

- (i) Community banking: Serving communities, not markets;
- (ii) Responsible finance, as it builds systematic checks on financial providers; and restrains consumer indebtedness; promotes ethical investment and CSR Initiatives;
- (iii) Alternative paradigm in terms of stability by linking financial services to the productive, real economy; also it provides a moral compass for capitalism;
- (iv) Fulfils aspirations in the sense it widens the ownership base of society, and offers 'success with authenticity.'

While similar notions can be found in Iqbal and Molyneux (2005), it is clear that these are the aspirations of Islamic economics as well. A

critical examination of these objectives, however, indicates that IBF is far from fulfilling these objectives due to the reasons explained so far. Examination of the 'assigned' values provides further evidence.

Regarding the first objective of community banking, real life experience shows that IBF has done little to contribute to capacity building in the communities. On the contrary, IBF has aimed at becoming part of the international economic markets and, 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" (Warde, 2000). This is so, since, "in the harsh environment of the global economy, [Islamic] banks must compete with conventional banks that usually focus exclusively on profit maximisation. [As] this allows them to offer better remuneration to their depositors and to their shareholders" (Warde, 2000: 154). Clearly, having profit maximisation as the primary aim negates the importance of societal responsibility and social identity.

Regarding responsible finance, there is no universally accepted regulatory body that systematically checks Islamic financial providers. The initiatives by AAOIFI in Bahrain and IFSB in Malaysia remain weak and are not generally adopted. To evidence this, Abdullatif (2007) shows that a large number of Saudi Islamic finance practitioners, as well as accountants and auditors, are largely unaware of AAOIFI standards.

As part of restraining consumer indebtedness, the data presented in the earlier section indicates that IBF institutions prefer involvement in transactions that are debt-financing oriented, as they are more profitable. Thus, this obligation remains unfulfilled.

Concerning ethical investments, restraining the investment areas of IBF does not necessarily make Islamic finance ethical. Rather, it only implies that IBF fulfils its legal expectations, as screening of Islamic investment is part of *shar'ah*. This is, precisely, what makes IBF active. However, considering that ethicality includes being pro-active, there is little indication that IBF is entirely ethical. This, again, refers to CSR initiatives, as recent studies on CSR of IBF demonstrate they have not pro-actively developed such an understanding. Their perceptions of CSR remain within the framework of *zakat* distribution and other non-systemic charitable activities (see Sorially, 2005 and 2007; Dusuki, 2007).

With its alternative paradigm and conflicting theoretical underpinnings, IBF is no longer part of the Islamic economic system and, therefore, does not exhibit meaningful macroeconomic

consequences. Granted, it may link financial services to the economy's productive side, but this is not convincing when considering the preferred financing is debt-financing as opposed to the original expectations that it would be equity-financing. Also, the most popular forms of financial activity remain the *murabahah* and lesser venture capital type of project financing. In that regard, it is difficult to argue IBF is related to the real economy beyond financing the retail markets. Furthermore, by becoming part of the international financial system through hybridisation, it is difficult to argue IBF plays the role of a moral compass for capitalism. On the contrary, it seems that IBF has much to learn from conventional finance in terms of ethical and CSR financing issues (Sarially, 2005 and 2007).

Pertaining to fulfilling aspirations, IBF has not positively affected social capacity building and contributed to widening ownership. Widening ownership could have been possible through venture capital or profit-loss sharing type of investments. However, as discussed previously, these do not seem to be preferred by IBF. It would seem that the characteristics of IBF do not reflect the Qur'anic economic meaning of authenticity or *shar'ah* based principles as located in the aspirational notions of Islamic economics. Instead, "[i]n Islamic finance, religion largely serves to obfuscate and complicate at some expense, while simultaneously and disingenuously asserting highly exaggerated claims of equity and social justice" (Hamaoudi, 2007).

5. SOCIAL WELFARE FUNCTION AND ISLAMIC FINANCE: RE-EXAMINING *MASLĀHAH*

It should be stated that social justice and economic development are the fundamental and foremost objectives of IBF. This is because the main epistemological source of these social objectives are derived from the *maqāṣid al-shar'ah*. However, a close examination of the *maqāṣid al-shar'ah* will show that it does not clearly indicate specifics concerning the social dimension or socio-tropic individual. The objective of the *shar'ah* (the Islamic way and code of conduct) according to al-Imām al-Ghazālī are as follows: "The obligation of the *shar'ah* is to provide the well-being of all human kind, which lies in safeguarding their faith, their human self (*nafs*), their intellect (*'aql*), their progeny (*nasl*) and their wealth (*māl*)." This clearly demonstrates that these are all individual oriented objectives and have no social connotations. This implies that references to the *maqāṣid al-shar'ah* and deducing

from it the social dimensions of Islamic economics which are then imposed on IBF, are not realistic. In other words, IBF has been defined by Islamic economics based on its own aspirational interpretation of *maqāṣid al-sharʿah*. Thus, the suggested value system that IBF needs to uphold is not properly defined. In this regard, it is also important to examine the nature of the *maqāṣid* because, as Siddiqi (2004) points out, a systemic and dynamic understanding of:

“*maqāṣid al-sharʿah* could not be confined only to protection (*hifz*), preserving what people had or saving them from harm, rather they must include broader measures ensuring welfare [as] asserted by Ibn Qayyim ... who emphasized justice and equity. Furthermore, he insisted that the means to justice and equity could never be captured by a finite list. Reason will guide us how to ensure justice and equity in changing circumstances (Ibn Qayyim, n.d.).”

It is crucially important, therefore, to distinguish:

“between the objectives of Islam, as a way of life and the objectives of Islamic Law [*maqāṣid-al sharʿah*]. The former involves aspects of personality and society the latter does not cover. Also, the former has a larger box of tools than available to the latter. [Therefore,] [e]nvisioning the Islamic economy in the twenty-first century is better done with reference to the goals of Islam as a way of life rather than being done with reference to the goals of Islamic Law. This will enable us to handle issues like poverty and inequality that a Law-based approach has failed to handle” (Siddiqi, 2004).

This point reinforces the earlier statement that Islamic economics has imposed an incomplete frame of reference or an aspirational framework on IBF.

Islamic economics, like neoclassical economics, suggests an implicit social welfare function, and expects Islamic finance to work towards that objective. However, neo-classical economic theory’s implicit social welfare function was undermined by the discourse and analysis developed by the new political economy and public choice (see Mueller, 2003), which still follows the utility maximising individual. The very idea that there is a social welfare function, which is assumed to be maximised by a benevolent authority is no longer a norm. This is so,

since, each government with their institutions are perceived to consist of individuals who attempt to maximise their own individual utilities in various capacities. In other words, the organic state with the social welfare function objective is no longer a reliable maxim.

Arguably, in the Islamic framework, the existence of the social welfare function and its maximisation by various actors in the society might be possible as religious norms essentialise the 'socio-tropic' individual. This is particularly evident since Islam aims to create *homoislamicus* or *taba'ay* individuals. However, developments in the evolution of IBF indicate, as contended by Kuran (1983), those norms have not emerged despite the increasing awareness of Islam. Interestingly, Siddiqi (2004) acknowledges that "even Islamic economists failed to come up with historical evidence and current empirical data on that kind of behaviour [that the acts of caring for others, serving social interest while protecting one's own, and avoiding doing any harm to man, animal or the physical environment are not a rarity], with some notable exceptions." Therefore, unless dictatorial rule takes place, which determines attitudes in the public sphere, the behavioural norms will follow an adaptive rationality in perpetuating neo-classical norms and will remain within the framework of neo-classical economics. Since dictatorial rule even failed to change the behavioural rules in Iran or in Sudan, there is little indication this might occur through voluntary action. Although voluntary action cannot be denied as an important source, it still is not enough to maximise the social function since the free-rider problem remains an issue. The (neo-classical) adaptive nature of behavioural norms would prevent social consensus as part of the ethico-economic system proposed by Choudhury (1990) to work. As a result, Choudhury (1985) assumes that "appropriate social policies progressively transform individual consumption preferences to make them conform with social preferences... The progressive conformity between individual and social preferences establishes Social Consensus." This indeed, refers to the aspirational nature of Islamic economics (where ethical norms are part of the behavioural norms through the endogenisation process) that fails to hold in the real world.

The social failure of IBF can also be explained by the pragmatist and legalistic attitude of individuals, as Vogel and Hayes (1998) propose when explaining prevalent attitudes towards IBF. They also see that the main strain in IBF is an attitude which can be described as "socially and politically conservative, seeking individual piety and social mores built around traditionalist compliance with *fiqh*, and looks to social and

political improvements mainly as a result of that” (Vogel and Hayes, 1998: 27, footnote). Thus, Islamic norms have not been instrumental in shaping individual choices and preferences, which is further evidence of the failure of *homoislamicus*.

Also, it is arguable whether Islamic economics even supports the principle of the maximisation of the social welfare function. This is so, since, there is no clear reference for this in the Islamic political economy framework. The only indirect reference is through the *maqāṣid al-sharʿah* which substantiates social justice, social welfare and the socio-tropic individual. However, as suggested by Siddiqi (2004), the *maqāṣid al-sharʿah* does not contain such a social objective because it is only related to the individual. This belief demonstrates a striking similarity with Adam Smith’s contention that the market economy would better serve social interest through the maximisation of individual interests. However, developments in capitalism have shown that individualistic attempts at maximising personal interest became the prevailing norm, and therefore Smith’s predictions did not hold. This is again related to behavioural norms.

6. SECOND BEST SOLUTION: FAILURE OF THE ISLAMIC ECONOMIC PARADIGM

The reality today indicates IBF does not represent the aspirations of Islamic economic philosophy nor fulfils the expectations of many Muslims in underdeveloped societies, for whom IBF was proposed as a way out. The current reality of IBF opposes the aspirations and philosophical framework of Islamic economics. The developments in Islamic economics and IBF, thus, indicate that the theoretical position of Islamic economics can be considered the ‘first best solution.’ It does so by borrowing a conceptual understanding from neo-classical economics. Moreover, in this ‘first best solution,’ like the conventional economics’ aim of creating *homoeconomics*, Islamic economics aims at creating *homoislamicus* by introducing and changing the behavioural norms of individuals. Therefore, its aspirational aims, supported by behavioural and philosophical norms, should be considered as the first 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 as well, as Kuran predicted in 1983. Whether Kuran’s argument is correct or ideologically acceptable to the founding fathers of Islamic economics, experience now shows that Muslim

individuals and Islamic banks remain affiliated to utility and profit maximisation. In addition, the available evidence clearly indicates that IBF institutions aim at efficiency by ignoring and relegating the importance of social efficiency. Thus, in the contest between economic and financial efficiency versus social efficiency as El-Gamal (2006) states, the choice has been economic and financial efficiency. This is an indication of the overwhelming power of *homoeconomicus* behavioural norms over *homoislamicus*.

As the first-best solution is not held in conventional economics, neo-classical economics offers the second best solution, in which *homoeconomics* still prevails but the failure of the market economy is overcome by offering a rationale for the creation of institutions that curb capitalist excesses. Similarly, the same analogy can be offered to the current state of IBF institutions and the consequences of their working mechanism. In other words, Islamic economics is currently undergoing the same experience and the conceptual framework of conventional economics can be used to explain this dilemma faced by IBF. This will correct the failure by bringing back the importance of ethical issues and social justice into the IBFs objectives, and therefore such conceptualisation should not be considered as *defeatist* but rather a *re-emergent* position.

Since Islamic economics' first-best solution of producing a financial system based on authentic moral ethics has not taken root, in the next stage of evolution the second-best solution must be accepted. The second-best solution recognizes the current nature of IBF institutions. Islamic economics behavioural norms and axioms in reality have been relaxed by the practice of IBF. This should be accepted as the norm instead of having a desperate state of mind that 'it went wrong.' In this second-best solution, IBF institutions are not expected to conduct social justice oriented activities beyond what they are legally required. Also, they are not expected to fulfil the ethical norms and to move beyond their legalistic requirements in relation to social issues.

However, the current important question is how social justice is to be served? What social-financial institutions can IBF offer to solve economic development issues in the Muslim world? While economic justice and protection from exploitation may not have been properly articulated by Islamic economics, it remains an important discourse in Islam and the prophetic tradition. Therefore, the search for fulfilling the imperative for social justice should continue. The institutions of Islamic economics, in order to overcome economic underdevelopment

issues, require considerable advancement and coherence. These institutions include *zakāh*, *waqf* and *takāful*. However, these are part of the legal responsibilities of IBF institutions. In other words, as part of the second-best solution, elimination of *ribā* would not result in a social welfare maximising state, despite the supportive remarks made in this direction by Tag El-din (2000). *Zakāh*, on the other hand, has not been systematically organised to serve the development needs of the society in a systematic manner. *Takāful*, again, is not a development oriented financial contract, while the creation of *waqf* is left to philanthropists.

It is important to note that at this stage of development, this paper does not suggest IBF should be restructured to incorporate the authentic Islamic axioms including social justice. On the contrary, they should be accepted as the second-best solution, due to the inability to establish the framework provided by the Islamic economic system. IBF, 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). However, social justice and developmental aims, including long-term financing and venture capital, can be structured in “a more specialized Islamic institutional set up ... in line with the recent global developments where a broad variety of institutional structures” exist as examples (Tag El-Din, 2004). This will provide for institutional corrective mechanisms that will ensure the second best solution yields the expected social outcome alongside commercial banking.

7. OVERCOMING THE FAILURE: (ISLAMIC) SOCIAL BANKING AS A WAY FORWARD

Clearly, as the discussion so far demonstrates, IBF has failed to internalise the social dimension and social justice into its own operational function. As a consequence, the second-best solution requires new models of development. In this new modelling or re-orienting “the brand name of Islamic finance [should] emphasize issues of community banking, microfinance, socially responsible investment, and the like” (El-Gamal, 2006). The difficult state of economic affairs in the developing world requires direct attention, which IBF, will not deal with. Therefore, paralleling the neo-classical framework, there is a need to

develop a welfare economics oriented paradigm, in which social justice and ethical norms can be exercised.

The need to moderate the consequences of the failure of IBF by utilising the second best solution, hence, is important. This moderation can be done by introducing ethics and social justice directly to the working of IBF institutions. In other words, in this moderating function, new institutions should be created as a new project for ethical Islamic finance beyond IBF, as the latter remains loyal to legalistic Islamic dimensions not Islamic ethics. In this effort, the evolutionary financial experience in the West can be taken as an example. Minsky et al. (1996), for instance, rationalise the existence of Community Development Banks (CBDs) by pointing to market failure, when they state that “when market forces fail to provide a service that is needed and potentially profitable, then it is an appropriate role for government to help create the market.”

The creation of ethical IBF and investment institutions, in the form of Islamic social banking, as part of civil society should be the next stage of financial development in the moral economy of the Muslim world. This too, should be aimed at social capacity building and individual functioning to create the right environment for economic development in a broad sense, as defined by Sen (1999). Granted, this is not entirely novel as the initial experience in Egypt mentioned earlier, was a social bank. Adding to the 1963 experience of Mit Ghamr Bank, “Nasser Social Bank (NSB) and the Faisal Islamic Bank (FIB) [in Egypt aimed,] as part of their missions [to alter] Egypt’s social structure by providing credit to poor Egyptians who would not otherwise be able to obtain credit” (Mayer, 1985). The philosophy that lay behind the Mit Ghamr Bank “was that Islamic banks should provide small loans to the poorest of potential borrowers not served by existing institutions, these being small peasants, small artisans, and urban workers” (Najjar, 1979 cited in Mayer, 1985: 38).

In this new stage, thus, equity-based finance, with direct involvement of civil society, as in the first example of Mit Ghamr, should be the solution. Boudjellal (2006: 31) is also of the opinion that, in addition to commercial Islamic banks, PLS (profit and loss sharing) type of banks in the form of “non-monetary financial intermediaries” can be institutionalised, which “use profit and loss sharing modes by holding equity stakes in selected business companies.” Such an institutional solution aiming at correcting and moderating the failure of IBF will contribute to the development of individual lives by focusing on societies’ micro-dynamics rather than affecting the financial equilibrium. This

fits into the new development paradigm, which has shifted focus from macro-economic development to micro dynamics. Thus, the involvement of IBF will lead to the maximisation of welfare in society by extending financial involvement to embrace the larger society in this economic dynamic.

Social banks, in its modern form, are practised in many European countries in order to provide ethical financing and, simultaneously, work towards micro development purposes. This is because it is a way forward to overcome banking exclusion and, also, aims to expand the ownership base of the society. Minsky et al. (1996) state that one aim of the CDBs, “should be to seek out projects which promise to be profitable but which will not be financed because of the small size of the project” and also provide financing in various dimensions for those who are excluded from the financial system.

Social banking is defined as “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” (Reifner, 2001). Also, social banks internalise the moral dimensions of the market system “to introduce ‘need orientation’ (Sen) into the exchange of commodities and services to further general welfare” (Reifner, 2001) of the society.

The European experience indicates mainstream private banks, state-owned banks and specialist lenders offer social lending and serve social objectives (Mayo and Guene, 2001). Therefore, social banking has a private banking nature as it works ‘in a competitive environment, necessitating profit orientation and cost cutting as major goals of its economic activity. On the other hand it implies a reference to social standards’ (Reifner, 2001). Thus, in addition to micro financing, social banks involve many social development projects as depicted in Table 1.

The examination of markets and needs in Table 1 show great similarity between aspirational IBF and social banking. Therefore, adopting social banking to IBF should not be a difficult exercise in terms of objectives. On the contrary, it will enable us to overcome some of the difficulties and tension areas between Islamic economics and the current state of IBF. Examining the nature of social banks further substantiates the claim that social banking can be considered as the new phase of IBF with *maṣlaḥah* objectives. Social banks, as 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

TABLE 1
Social Banking Target Markets

Market	Examples of Needs
Low-income consumers consumer credits	Saving mechanism, payment service
Small business finance	Development finance
Micro-enterprise for individuals and family	Start-up/working capital, business skills
Third system social enterprise	Project finance, working capital, facility finance
Ecological enterprise	Development finance

Source: Mayo and Guene (2001)

the classical public or private sector forms” (Mayo and Guene, 2001), as they:

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

In highlighting the importance of social banks, the European Commission identifies its necessity by stating: “The social economy and the activities oriented to meet the need unsatisfied by the market can lead to the development of a new sense of entrepreneurship particularly valuable for economic and social development at local level. This sense of entrepreneurship is closer to the aspirations and values of people that

do not seek profit making but rather the development of socially useful activities or jobs. These forms of entrepreneurship have a useful role in promoting social cohesion and economic local performance” (cited in Mayo and Guene, 2001).

Social banking should not only be considered as development oriented banking. On the contrary, as the European examples show, they provide personal financial services including bank accounts, mortgages and small business lending activities. In other words, the social nature of these banks does not imply that they are not financial institutions. Rather, they are banks aiming to achieve financial efficiency and use this to promote social efficiency. As Mayo and Guene (2001) state “the social dimension allows the financing institutions to innovate around method [social objective] to reduce risk and improve returns.” Without this, social banks would repeat the experience of IBF by duplicating or mimicking mainstream banking by supporting bankable projects only. “Instead, social banking methods widen the frame of those able to access finance” (Mayo and Guene, 2001) and thereby contributes to the cohesion of social and economic objectives.

Reifner (2001) suggests that the introduction of social standards into the objectives function of banks is by the following:

- (i) internal moral standards of social responsibility from the corporate identity and market image of the bank, or:
- (ii) through legal obligations for community reinvestment and equal treatment of citizens, or:
- (iii) merely by the pressure of institutional investors and other customers who are willing to act as agents of public goals.

In checking the extent to which social banks complement IBF, it is clear that *maṣlaúah* provides the moral standard for social good, and *sharʕah* requires justice and benevolence. Therefore, banks are encouraged to develop a consciousness concerning the consequences of their business beyond narrow *sharʕah* compliancy into pro-active thinking. This should be satisfactory enough for IBF institutions to practise social banking. IBF, being specialised banks, have the experience and the knowledge of developing “new products and procedures for the distribution and administration of financial services which promise better social effects for users and society, without creating losses and disadvantages for the general business of its provider” (Reifner, 2001). Therefore, after thirty years experience of IBF industry,

Ahmed (2004) also is of the opinion that the “social aspect of Islamic banks can be best realized by financing the poor micro-entrepreneur” in the contemporary world.

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). Thus, as Siddiqi (2004) argues, a move towards goals and policy rather than the mechanistic and legal structure of IBF will serve human well-being much better.

8. CONCLUSION

Islamic economics relies on behavioural norms to encourage the growth of a social welfare maximising state shaped by its foundational axioms. However, thus far, those aspirational expectations have not materialised in the operational side of Islamic economics, namely IBF. In opposing the views of Islamic economists, Kuran (1983 and 1995) argues that religious norms are not enough to change people’s economic behaviour (in creating *homoislamicus*) when they face the problem of maximising their utility and welfare. Therefore, he finds that the main shortcoming in IBF, and hence the source of its failure, is economic incentives. Empirical evidence discussed earlier suggests that Kuran’s prediction was right, as economic incentives not religious norms determine the structure of Islamic financing in the current economic order. This is evidenced with the lesser financing extended to *mushārakah* and *mudarabah*. Importantly, the failure of holding the norms of Islamic economics on an individual level, not only institutionally, remains as an enduring quagmire that Muslims must recognize and re-evaluate in regards to the direction of societal development.

The aim of Islamic economics is novel by making reference to social justice and well-being. It is a fact that under no circumstances can economic incentives fulfil such objectives in Islamic or conventional economics. Therefore, correcting the failure of IBF, which has deviated from the aims of Islamic economics, should be in the form of introducing robust social justice oriented principles, or by institutionalising and endogenising social justice into its operational nature as social banks. This will help to establish optimality between “venal behaviour for one that is profitable but unethical, and ... sacrificial behaviour for one that is ethical but not profitable... [and the] choice [is indeed] relative to the values of the actors and the interest at stake” (Le Menestrel, 2002).

There is, therefore, a need to go beyond the legal interpretations and literal reading of the text. A value and objective oriented approach would help overcome the growing tension between IBF's performance and Islamic economics' utopia. This is possible by recognising and diagnosing the problem that the first-best solution, based on the axioms and foundational principles of Islamic economics, has failed and IBF has come out as the second-best solution. By using the analogy of the neo-classical theory, IBF has to move into the third stage of institutional development by introducing social banking into the market to correct its *social failure*. With the existence of such banking institutions, it will be possible to respond to the growing economic development need of society by increasing the social capacity of individuals and make them 'functioning,' as Sen (1999) defines them and as Islamic economics aims for.

This is the objective of the Islamic economic system: to create equilibrium between scarce resources and unlimited needs through a moral filter system that produces a socially and financially optimal economic state. Also, in that economic state, human well-being is served through inclusive policies and economic value creation oriented economic activity (Chapra, 2000). In other words, goals and objectives should have primacy over rules and regulations so that the correct institutions and financial products can be created for need fulfilment (Siddiqi, 2004). Islamic social banking, thus, can provide the "new identity based on substantive and ethical religious tenets" (El-Gamal, 2006: 191) on the growth of IBF institutions for a better future, a future in which opportunity spaces can be created for achieving prosperity in this world and in hereafter, (*falĒū*), through purification and perfection of individuals and institutions for growth and development, as *tazkiyah* suggests.

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