THE OBJECTIVES AND PERFORMANCE MEASURES OF ISLAMIC BANKING BASED ON MAQASID AL-SHARI'AH FRAMEWORK

by

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"When the son of Adam dies, all (the rewards for) his deeds are savoured except for three things (whose rewards are infinite): a perpetual charity, knowledge that is beneficial and a pious child who continuous to make doa for the deceased". Hadeeth

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LIST OF KEY TERMS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institution
Al-Bay' Bithaman Ajil	Deferred payment where the good is delivered on the spot and the payment is by instalment
Al-Dawah	Propagation or inviting people to Islam
Al-Ghish	Deception
Al-Ijarah	Lease contract
Al-Istisna	Contract used in manufacturing, construction and project financing
Al-Maqasid	Intention or objective. Normally it is used as a short form for Maqasid al-Shari'ah
Al-Mudarabah	a joint venture contract where one party contributes capital and the other party manages the business. Both parties share profit but loss is borne by the capital owner.
Al-Murabah	Sale on cost plus profit
Al-Musharakah	a joint venture business where both parties contribute capital and they share profit and loss
Al-Muzara'ah	Partnership in agriculture on the basis of profit and loss sharing
Al-Qard	Loan advanced to fulfill needs. Payments of such loans are on equivalent values without charges on the principle.
Al-Salam	Forward sale where payment is made on the spot and the good is delivered in future
Al-Tadawul or al-Rawwaj	Wealth circulation
Al-Tas'eer	Pricing, normally administrative pricing
Al-Tawheed	The process of unification towards Allah
Dar al-Mafasid	Prevention of harm or vices or corruption

Daruriyat	Necessities
Daruriyat al-Khams	The five essential elements, which are the preservation of religion, individual, intellect, progeny and wealth
Diwan (Pl. Dawawin)	A hall used as a place for financial activities in Muslim Caliphate in the 8^{th} Century
Gharar	Creating unnecessary risk or uncertainty
Hajiyat	Complements, elements that facilitate the implementation of Daruriyat
Ihtikar	Monopoly or hoarding a commodity with the intention of pushing up the prices
Iqamah al-Adl	Establishing justice
Islamic windows	Dual banking system where conventional banks are allowed to open Islamic banking unit or window in their businesses
Jahalah	Information asymmetry between buyer and seller regarding the good or price or market conditions
Jalb al-Masalih	Promotion of welfare or wellbeing
Mafasid	Harm or vices or corruption
Maqasid al-Shari'ah	The objectives of Shari'ah
Maslahah	Welfare or wellbeing
Maysir	Gambling or speculation
Sadaqah	Charity
SAMA	Saudi Arabian Monetary Authority
Sarrafin or Sayarifah	Financial clerk or expert in matter of coins
Sukuk	Islamic bonds
Sukuk al-Ijarah	Islamic bonds structured using lease contract
Tahdhib	Disciplining
Tahdhib al-Fard	Disciplining the self through education and learning

Tahsiniyat	Embellishments, elements related to acts of morality and ethics
Takaful	Mutual care, the term is now used for Islamic insurance
Waqf	Islamic form of endowment

UKURAN OBJEKTIF DAN PRESTASI PERBANKAN ISLAM BERASASKAN RANGKA MAQASID AL-SHARI'AH

ABSTRAK

Seketika pertumbuhan perbankan Islam mencapai tahap yang memberangsangkan, kajian-kajian mengenai prestasi perbankan Islam menunjukkan bahawa bank-bank Islam masih ketinggalan dibelakang perbankan konvensional. Di samping itu, ada juga perdebatan tentang titik pertemuan perbankan Islam dengan sistem konvensional. Perkara ini menampilkan persoalan kajian penting yang bertanyakan samaada prestasi buruk bank-bank Islam disebabkan oleh ketidaksuaian antara objektif dan kriteria prestasi atau refleksi prestasi yang sebenar? Sejauh ini, kebanyakkan penyelidikan berdiam diri tentang persoalan kajian yang penting ini. Setakad ini tidak terdapat kajian formal tentang objektif perbankan Islam atau sebarang ikhtiar untuk meniliti dengan terperinci kegunaan ukuran prestasi bank konvensional yang berkemungkinan tidak serasi dengan objektif bank-bank Islam untuk mengukur hasilnya. Kajian kali ini bertentangan dengan trend tersebut. Kajian ini juga adalah percubaan untuk mengisi jurang dalam penyelidikan dengan mengenalpasti objektif perbankan Islam melalui teori Maqasid al-Shariah. Objektif berikut akan digunakan sebagai asas untuk membangunkan Ukuran Prestasi Perbankan Islam yang berasaskan Maqasid al-Shariah atau model PMMS. Model ini berserta Ukuran Prestasi Perbankan Konvesional atau model CBPM diuji terhadap 24 sampel bank (12 bank Islam dan 12 bank konvensional) menggunakan kaedah statistik bukan parameter Mann-Whitney U-Test. Hasil ujian tersebut menunjukkan bahawa bank-bank Islam mencapai prestasi baik yang luarbiasa apabila model

PMMS digunakan berbanding dengan ukuran menggunakan model CBPM. Hasil ujian tersebut juga mengesahkan ketidak serasian objektif perbankan Islam menggunakan kayuukur konvensional untuk mengukur hasilnya.

THE OBJECTIVES AND PERFORMANCE MEASURES OF ISLAMIC BANKING BASED ON MAQASID AL-SHARI'AH FRAMEWORK

ABSTRACT

While the Islamic banking (IB) industry has achieved a remarkable growth, studies have shown that the performance of Islamic banks is trailing behind their conventional counterpart. Besides, there are contentions that IB is converging towards the conventional banking (CB) system. This does bring into fore a pertinent research question whether the poor performance of Islamic banks is due to the mismatch between their objectives and performance criteria or it is really a true reflection of their performance. So far, the vast majority of research has remained silent on this important research question. There has never been any formal study on the objectives of Islamic banking, nor has there been any effort to explore the possibility of mismatch between the objectives of Islamic banks and the conventional banking performance measures used to measure their results. This study has gone against these trends. It has tried to fill in the research gap by identifying the objectives of Islamic banking from the theory of Maqasid al-Shari'ah and then used these objectives as bases for developing the Islamic Banking **P**erformance **M**easures based on **M**aqasid al-**S**hari'ah or the PMMS model. The model, along with Conventional Banking Performance Measures or the CBPM model, were tested on a sample of 24 banks (12 IB and 12 CB) using the Mann-Whitney U-Test non parametric statistical method. The results of the tests show Islamic banks performing remarkably good when measured using the PMMS model compared to when they are measured using the CBPM model. The results show evidence of a mismatch between

the objectives of Islamic banking and the conventional yardsticks being used to measure their results.

CHAPTER 1

INTRODUCTION

1.1 Background of Study

Banking as a financial institution has become so vital to almost all modern economies that governments, firms and individuals cannot afford to do without. Governments use banks especially the central banks, among others, to regulate and supervise the health of their economies. Firms and individuals rely on banks for savings, investments and the purchases of goods and services. Modern banks through financial intermediaries are central to the activities of the product and factor markets. The rapid changes in government regulations, technologies and financial innovations due to globalization have resulted in more banking facilities. Such facilities include the provision of banking services through electronic channels, namely Automated Teller Machines (ATMs), Personal Computer (PC) banking, phone banking, banking kiosks, credit cards, debit cards and prepaid cards to mention but a few. These changes have revolutionized the way people raise and use their money.

The dominant banking system, since the colonization of the last Muslim Caliphate in 1924, has been the conventional banking system. It is basically a debt based system where the interest rate mechanism plays a central role in pricing almost all its product and services. Profit maximization still remains the dominant goal of the conventional banking system. On the other hand, there is the Islamic banking system. While there are some similarities between the functions of conventional banking and Islamic banking systems such as saving function, wealth function and policy function, yet there are also some fundamental differences the two systems. Islamic banking is guided by the Shari'ah. Hence, it prohibits Riba (which includes interest), gharar (speculation) and Maysir (gambling) in its operation. The Islamic banking system is essentially based on the philosophy of Tawheed or the unity of Allah. The concept of Tawheed, which is derived from the Arabic verb 'wahhada' (unification), signifies that at every time, every place and every situation, Muslim thoughts, words and actions must unify from and towards achieving the objectives of Shari'ah. Cognizant of these values, the Muslims realized that there was a need for them to come up with a new banking system that should be able to offer nearly all the services being offered by modern banking but based on the values of Islam.

1.2 Evolution of Islamic Banking

The concept of banking and its activities may not be alien from the early days of Islam. Nasir (1996) attributes the 'bank' of al-Zubair Ibn al-'Awwam, the companion of Prophet Muhammad (s.a.w.), as perhaps among the first banking activities during the early days of Islam. According to Nasir (1996), al-Zubair used to receive deposits from the public, invest them and jointly share the profit. Hamud (1976) citing al-Tabaqat al-Kubra states that the value of deposits with al-Zubair was estimated at 2.1 million Dirham, which was quite a substantial amount then (as quoted by Nasir, 1996). Furthermore, Nasir mentions that al-Zubair had several 'bank' branches in Cairo, Alexandria, Kufa and Basra (the first two cities are located in the present day Egypt and the latter two in Iraq).

Nasir's (1996) view is complemented by Chachi (2005) who showed in his article that banking operation was also practiced by the Muslims as early as 8th Century. He dispelled the notion of novelty that banking originated from the 12th Century Italy. Citing the historical writings of al-Qalqashandi (1913), al-Djahshiyari (1938), Pellat and Sachacht (1965), al-Kubaisi (1979), al-Ali (1953, 1981), al-Saadi

(1958), al-Duri (1986, 1995), Fischel (1992), al-Hamdani (2000) and Chapra and Ahmed (2002), Chachi (2005) illustrated that there were the existence of banking institutions as well as the presence of bankers who were called sarrafeen or sayarifah or djahabidhah. The banks were called dawawin al-djahabidhah. They functioned without recourse to interest. According to Chachi (2005), from 8th century, the term djahbadh (plural djahabidhah) was used in the sense of financial clerk, expert in matters of coin, skilled money examiner, treasury receiver, government cashier, money changer or collector to designate the well known licensed merchant banker in the time of the Abbasid Caliphate.

The common traits in those early models of 'Islamic banking' were the abolition of Riba, Maysir (gambling), Gharar (speculation and unnecessary risks), Ghubn (deception), Ihtikar (hoarding and monopoly) and Jahalah (information asymmetry), among others. These negative elements were prohibited because their presence cause injustices and undermine Maslahah (human welfare). Other common traits included the use of business modes that promoted risk sharing ventures, mobilized factors of production and were directly related to real economic activities. These profit and loss sharing modes included Musharakah (Equity partnership), Mudarabah (joint venture partnership), Muzara'ah (Partnership in agriculture), al-Istisna (manufacturing or project financing), al-Salam (forward sale) and al-Murabahah (cost plus sale). Besides these financial modes, those 'Islamic banks' also contributed greatly to redistributive institutions such as Zakat, Waqf and other forms of Sadaqat (Charities). The focus of these 'Islamic banks' was mainly to contribute to the growth in the real economy and their relationship with the customers was investment driven (Mirakhor, 2008). Loan or Qard were only used for consumption in situations of dire needs.

The last practice of the early Islamic banking model ended in 1924 with the collapse of the Ottoman state after the First World War. That year also marked the final colonization of almost all the Muslim countries. As a result, the entire socio-political and economic systems of these countries, including banking, were replaced. The colonial masters introduced new laws, rules and regulations, techniques and institutions based on secularism to substitute the erstwhile systems in the Muslim countries. The colonialists instituted a debt system that over time became detached from the real economy. The debt system operates on the interest rate mechanism, reinstituting Riba, Gharar, Maysir and all the negative elements that create injustices in the system. The rules and regulations were formulated to support and sustain the debt system. Hence, the systems in many Muslim countries operated on this secular structure.

In the late 19th century, several Muslim countries began to attain independence and there was hope, in this newly founded freedom, that the Muslim Ummah would resort to their heritage to rediscover themselves. The Islamic revivalism (al-Sahwah al-Islamiyyah) brought about a surge of Islamic self-identity and an inspiration to adopt Islam as a way of life in all spheres, including economics and finance. Muslims became keener than ever before to establish an economic and financial system that is based on the values of Islam. Hence, the idea of establishing modern Islamic banking finally materialized, with the view that the expected Islamic banks would offer an interest free alternative to the interest based conventional financial institutions (Islam, 2000).

1.3 Modern Islamic Banking

There are varying opinions about the exact date and origin of the modern Islamic banking. Wilson (1983) states that the first attempt to establish an Islamic financial institution took place in Pakistan in the 50s. It was an experiment initiated by some pious land lords. Money was deposited and borrowed without interest. There are also views that the first model of the modern Islamic banking was the Mit Ghamr Savings Bank in Egypt (Ahmad, 1989). The bank neither paid interest to their depositors nor charged any from the investors. The bank money was invested mostly in trade and in the profit and loss sharing projects. The bank lasted for only 4 years until 1967 (Ariff, 1988). Other scholars opine that the modern Islamic banking evolved from the Malaysian Pilgrim Funds in 1962 earlier than the Mit Ghamr (Kahf, 1999). Nevertheless, the establishment of the first formal Islamic bank, Dubai Islamic in 1974, followed by the establishment of the Islamic Development Bank (IDB) in 1975 under the auspices of the Organization of Islamic Conferences (OIC) marked a very important milestone to the development of the Islamic banking and finance.

Compared to the modern conventional banking, which has been around for over 900 years since the 12th Century A.D Italy (Chachi, 2005), modern Islamic banking is only slightly over 40 years old since the establishment of the first bank, the Dubai Islamic Bank in1975. However, the expansion and performance of Islamic banking within this period has been remarkable inspite of operating in a competitive environment along side its conventional counter-part. There are several reasons that led to this remarkable spread of Islamic banking and finance, notably positive changes in the stance of Muslim governments towards Islamic banking, increasing wealth of Muslim nations, expansion of Islamic banking services and products, and global demand and markets for Islamic banking.

In the seventies and eighties, most Muslim governments had been indifferent in their stance towards Islamic banking. Vogel and Hayes (1998, p.11) classified the modern Islamic financial system based on Muslim government stance into four:

1. There are those that have transformed their entire internal financial system to an Islamic form (Iran, Pakistan, Sudan)
2. Those that embrace Islamic banking as a national policy while supporting dual banking tracks (Bahrain, Brunei, Kuwait, Malaysia, Turkey, United Arab Emirates)
3. Those that neither support nor oppose Islamic banking within their Jurisdiction (Egypt, Yemen, Indonesia).
4. Those that actively discourage a separate Islamic banking presence (Saudi Arabia and Oman)

From the four classifications above, the first and second classifications had been the main driver of the Islamic banking industry. For example, Malaysia developed a banking law in 1983 (BNM, 2011) at a time when many of the Muslim governments in the other classifications were still relying on conventional banking acts. Bahrain's Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which was established in 1991 has since then produced more than 70 Shari'ah and Accounting standards for Islamic banks (AAOIFI standard, 2007).

Over the years, Muslim governments' stances in Vogel's last two categories, 3 and 4 have positively changed tremendously in favour of Islamic banking. They have increasingly rendered technical, regulatory and moral support to the development of the Islamic banking industry. In the third classification for example, Indonesia has graduated from the stance of those governments that neither support nor oppose Islamic banking within their Jurisdiction. As a result the number of banks offering Islamic banking services in Indonesia grew from only one bank in 1991, two banks in 1999 to 92 in 2008 and to 149 in 2010 (Bank Indonesia, 2011). In 2008, Indonesia developed a three phase strategy for the development of its Shari'ah banking industry (Bank Indonesia, 2011). The first phase assigns a new vision of Islamic banking development; the second stage aspires to make Indonesia's Islamic banking industry the most attractive in ASEAN and the third phase is suppose to transform the industry as ASEAN leader. In line with this vision, recently, on 25thOctober 2010, Bank Indonesia together with 10 other central banks and two multilateral organisations signed an agreement in Kuala Lumpur, Malaysia to establish the International Islamic Liquidity Management Corporation (IILM). The agreement besides facilitating investment inflows to the Islamic financial services industry among the signatory countries; it is also aimed at assisting institutions that offer Shari'ah based financial services in managing their liquidity (Bank Indonesia, 2011).

In the fourth category, Saudi Arabia for example, was considered among those countries that actively discourage a separate Islamic banking presence. This was at a time when non-Arab countries such as Malaysia were calling for the need to formalise their Islamic financial system. In the 1980s, when the idea for establishing Islamic banks was first proposed to the Saudi government, it was assumed that banks in the country were Islamic by default and thus there was no need for a separate license for Islamic banks. According to Wilson (1991), the Saudi Arabian Monetary Agency (SAMA) – equivalence of a central bank - and the Ministry of finance were reluctant to issue any Islamic banking licence. The Saudi authority changed its stance only after the intervention of Prince Muhammad, King Faisal`s son, who obtained his degree in business from Menlo California (Wilson, 1991). Thereafter, few Islamic banks emerged. Prominent among them is Dallah al-Barakah and Al-Rajhi, which had to wait for five years for the approval of its license (Wilson, 1991). Today, Saudi Arabia is the country with the largest share of Islamic banking assets in the entire Gulf region. In 2008, it captured 45% of the total Islamic banking assets among the five Gulf Cooperation Council (GCC) member countries (Standard & Poor's, 2011).

The second reason that led to the remarkable spread of Islamic banking and finance is the increasing wealth of Muslim nations. The oil boom in the seventies brought about unprecedented affluence and surplus savings particularly to the oil rich Middle Eastern states (Vogel, et al, 1998). According to the economic report from BLOMINVEST bank (2009), the increasing global dependence on oil, and higher oil prices have led to a per-capita GDP increase of 85-130% in Pakistan, Jordan, Malaysia, Bahrain, and Saudi Arabia between 2000 and 2008. Furthermore, based on the report, excess liquidity has created enormous development opportunities in Muslim countries and it is estimated that more than USD 2.91 trillion worth of development projects since 2008 were making ways to the Gulf Cooperation Council (GCC) project finance market. According to McKinsey (2008), the export of crude oil will earn to GCC countries between USD 5 trillion and USD 9 trillion from 2007 to 2020 (depending on the prevailing oil prices). These surpluses accumulated over the years will have a profound impact on Islamic banking and finance.

The rapid growth of Islamic banking is also attributed to the expansion and diversification of the Islamic banking services and products. In the seventies, the industry only relied on few retail banking products. Today, Islamic banking and finance industry has expanded its products and services to include money markets and inter-bank money market products, capital markets products, particularly sukuk or Islamic bonds, Shari'ah compliant stocks in the equity markets besides establishing various funds which varied with the risk appetite of its investors and providing education and training programs in the related fields. These arrays of products and services are also responses to the increasing global demand and markets for Islamic banking. This global demand is reflected in the market share and asset size of Islamic bank worldwide, increasing number of non Muslim countries and institutions offering Islamic banking products and services, and the ethical attraction of Islamic banking.

Up to May 1997, twenty two years after the inception of the first Islamic bank, there were already about 150 Islamic banks and financial institutions managing investments estimated at about USD 75.5 billion in Asia, Africa, Europe and the U.S., covering more than 27 countries (Kamel, 1997). In 2005, a study by the International Monetary Fund showed that the number of Islamic financial institutions increased from 75 in 1975 to more than 300 in 2005 and arespread across more than 75 countries globally. A follow up study by McKinsey, The World Islamic Banking Competitiveness Report (2007-08), two years later showed that Islamic finance has been expanding at an annual rate of 15 – 20%. The total assets managed by Islamic financial institutions in 2008 was estimated to be between USD400 billion to USD500 billion and, the potential market for Islamic financial services was then close to $4 trillion (Al-Amine, 2008). A recent survey by The Banker (2010) of financial institutions practicing Islamic finance reveals that Shari'ah-compliant assets rose by 8.85% from $822billion in 2009 to $895billion in 2010.

Due to the global demand and the existence of huge under serving market, non-Islamic financial institutions globally have also begun developing interest in Islamic banking. They have begun positioning themselves aggressively to tap resources and investment opportunities and capture the market share of the booming Islamic financial industry (Askari, Iqbal & Mirakhor, 2009). In America and Canada for example, the activities of Islamic banking were valued at USD 1.5 billion and USD 86.1 million respectively (Ranzini, 2007). According to the report by the International Financial Service London (IFSL, 2010), there were 22 institutions in U.K. offering Islamic banking services, more than in any other western countries. The issuance of sukuk in U.K. increased rapidly from $1billion a year in 2002 to $34billion in 2007. There are 20 major law firms providing legal services in Islamic finance. On the other hand, "Courses in Islamic finance are offered by the Chartered Institute for Securities and Investment (CISI), Chartered Institute of Management Accountants (CIMA), Association of International Accountants (AIA), Cass Business School (CBS) and the Institute of Islamic Banking and Insurance (IFSL, 2010). Singapore is another non Muslim country that has taken active role in Islamic finance since it first launched its sukuk in 2001. Besides sukuk, Singapore has been focusing in areas such as hedge funds, Takaful, wealth management and property investment (Khan & Bhatti, 2008).

Besides the global demand Islamic banking and finance has remained attractive due to its ethical appeal and it is also now being seen as a viable alternative to the economic and financial problems of mankind. For example, BLOMINVEST bank (2009) citing Washington Post reported that U.S. Deputy Treasury Secretary, Robert Kimmet, announced that experts at the treasury were then studying features of Islamic banking as a less risky banking option in the face of turmoil following the 2008 global financial crisis. Moreover, regarding the same issue, the Vatican was cited to have said banks should look at the rules of Islamic finance to restore confidence amongst their clients at a time of global economic crisis (Totaro, 2010).

According to the Vatican, “The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service” (Bloomberg.com, 2010)

1.4 Islamic Banking in Malaysia

Malaysia’s Islamic banking industry is another example of a success story. The banking industry in Malaysia developed drastically and steadily following a well planned vision as enshrined in the country’s Financial Sector Master Plan (FSMP). Below are some of the important milestones that Malaysia has gone through to claim the success it deserves, as reported in the Bank Negara Malaysia (BNM) website, (http://www.bnm.gov.my, 2005).

In 1969, the Pilgrims’ Fund Board (Lembaga Tabung Haji) was established for systematic mobilization of funds to assist Muslim community to perform Pilgrimage as well as participate in investment and economic activities. In 1980, the Bumiputera Economic Congress proposed the setting up of an Islamic bank, driven then by the growing urge for the revival of Islamic values amongst the Muslim population and the successful implementation of Islamic banks in the Middle East. Meanwhile in 1981, the National Steering Committee undertook a study and made recommendations for the establishment of an Islamic bank. Accordingly, the Islamic Banking Act (IBA) was enacted in 1983. In the same year, Bank Islam Malaysia Berhad (BIMB) was incorporated as Malaysia’s first Islamic bank followed by the enactment of the Government Investment Act (GIA) to allow the issuance of government papers and bonds. In the following year, 1984, Takaful companies were set up to complement the operations of Islamic banks.

In 1992, BIMB was listed on the Kuala Lumpur Stock Exchange (KLSE) and in the following year, 1993, the Dual Banking System was implemented, allowing Islamic and conventional banking to co-exist and run concurrently in the financial system.

The year 1999 witnessed the incorporation of Bank Muamalat Malaysia Berhad (BMMB as the second full-fledged Islamic bank. In 2000, the Association of Islamic Banking Institutions of Malaysia (AIBIM) was established to harmonize and streamline Islamic banking practices. Still in the same year, an industry owned training institute, Islamic Banking and Finance Institute Malaysia (IBFIM) was established.

The year 2002 saw the introduction of standard generic names for Islamic banking products, for example savings account-*i*, current account-*i*, home financing-*i*, hire purchase-*i*, cash line facility-*i*, share-financing-*i*, working capital financing-*i*, letter of credit-*i* . This was followed in the same year by the introduction of Islamic banking logo to increase visibility, provide branding of Islamic financial products and reflect commitment of the development of Islamic banking and finance. The same year witnessed another activity at a global level, Malaysia issued the first global sovereign *sukuk al-ijarah* bond.

In the year 2006, the International Islamic University Malaysia (IIUM) established the Institute of Islamic Banking and Finance (IIiBF) to offer various postgraduate programs in Islamic banking and finance, namely PhD, Masters and postgraduate diploma. Besides, IIiBF also offers certificate courses, training programs, consultancy and contract research in Islamic banking and finance. These programs and services are not only demanded in Malaysia but also highly demanded abroad. IIiBF was later followed by the establishment of the Department of Islamic

Banking and Finance in 2010 in its Economics and Management Sciences faculty to carter for undergraduate programs. With these developments, the University now offers full range of complete undergraduate and postgraduate programs in Islamic banking and finance. Since its establishment in 1983 IIUM has been championing the development agenda of Malaysia by constantly providing the necessary human resource, research, training and consultancy to support the growth of the Islamic banking industry.

The year 2006 also witnessed three other important activities, namely Kuwait Finance House became the first foreign Islamic bank to begin operation in Malaysia, the International Centre for Education in Islamic Finance (INCEIF) was established and finally the launching of Malaysia International Islamic Financial Centre (MIFC) in August 2006 by BNM to enable the country to position itself as a platform for international Islamic financial hub.

All these initiatives have produced overwhelming results for Malaysia's banking industry. The number of products offered by the Islamic banking industry increased by over six folds to 64 products (as of April 2006) from less than ten products in 1983. Malaysia's Islamic banking assets reached USD65.6 billion with an average growth rate of 18-20% annually in 2008 (BNM, 2008). Although the Kuala Lumpur Stock Exchange (KLSE) Islamic index was introduced in 1999, over 80% of the stocks listed in the Bursa Malaysia as of 2010 were Shari'ah compliant (Securities Commission, http://www.sc.com.my, 2010). The Malaysian Islamic capital and money markets are considered among the most developed in the Muslim world and Malaysia is considered to be among the premier country to issue the global Sukuk sovereign bond in 2002, valued at USD 600 million. (BNM, http://www.mifc.com, 2009).

1.5 Issues on the Objectives of Islamic Banking and Its Performance Measures

Therefore, apparently the Islamic banking industry seems to be expanding rapidly and it is becoming a viable alternative to the existing conventional banking system. However, on the other hand, there are increasing contentions regarding the direction of the Islamic banking industry. One such contention is that Islamic banking seems to lack a clear sense of direction and well defined Shari'ah objectives; hence it is converging towards the conventional banking system. This contention is firstly grounded on the fact that, due to the colonial factors that we have discussed above, the entire Islamic banking industry still operates on the conventional rules and regulations (Khan & Chapra, 2003). This means that the entire structure is debt based (al-Salamee, 2006). The debt structure is based essentially on lending and borrowing, treats money as a commodity, operates using the interest rate mechanism and defines the customer-bank relationship as debtor-creditor relationship. The entire rules and regulations are formulated to support and sustain the structure. The debt structure has also been criticized for being self-centred (Chapra, 1985), hence impoverishing poor nations (Afzal, 1990). In fact, it has also been blamed for the 2008 global financial meltdown (Askari & Krichene & Mirakhor, 2010). Besides, interest, which is the basis for the operation of the debt structure, has been blamed for many moral ills (Afzal, 1990). Interest is also seen as being responsible for trade cycles (Siddiqi, 2004). In short therefore, conventional debt structured banking is seen as a system that is unjust and individualistic, which goes against the Islamic objectives of justice and Maslahah (public interest).

The second reason for the contention is that those who established the modern Islamic banking and finance were conventionally trained (al-Salamee, 2006). They were bounded to establish it based on the structure that they were familiar with – the debt structure. Thirdly, most of the modern Islamic banks still conform to international standards on accounting, regulatory framework and trade rules. These standards are basically conventional and are meant to support the debt structure.

There are also contentions that the modern Islamic banking has lost direction because it has focused on the prohibition of interest. This alone, it is said, is not sufficient to free the industry from the entire debt structure. In fact, Islamic banking laws in many Muslim countries still patronize the debt system. The bank-customer relationship is still based on loan and the Islamic banking still depends on the interest rate mechanism for pricing their products.

According to al-Salamee (2006, p.3), "overtime, the Islamic banks turned towards the western model and, the western banking mechanism attracted them so much that they had to replicate this western model under a superficial cover". Al-Salamee (2006) who is also the Chairman of Shari'ah Advisory Council of Islamic Development Bank (IDB) adds the following comments regarding Islamic banking and its objectives:

> The Islamic banks since their inception were not able to entrust their steering wheel to those who comprehend the idea, objectives and strategies of Islamic banks. This is because the entire mechanisms of Islamic banks were based on the Western models and techniques, and the practioners conducted their operation based on what they learnt from the conventional banks. Therefore there was no other choice except to rely on them, after highlighting some Islamic banking objectives and techniques, particularly the objective related to the avoidance of riba. Through them (practioners), it was possible to drive the wheels of those institutions forward to practical reality, thus removing the Islamic financing institutions from the realm of imagination and placing them into the sphere of practical reality. Some of the facts that cannot be ignored are that most of these mechanisms are still bounded to what they have been brought up with and to what they have passed through in their practical life, which conforms to the western interest based system. The role of this system in influencing future Islamic banking mechanisms is still evident. (Al-Salamee, 2006, p. 4)

The present scenario of Islamic banking has also been described by al-Sheikh Saleh Abdullah in a forum on 'developing the Islamic financial sector' held in Kuwait on 28th May 2006, where he said,

> We must transcend the conventional system and its replication, and move towards origination and taking initiatives. Many have been affected by the experiment of Islamic banking. We have confined ourselves for decades in finding outlets and legal stratagems (Hiyal) for initially interest based transactions. Due to additional papers and minor procedures, we tried to change the basis to Islamic mode of transactions. However, the basis still remains faithful to its interest based source and economic role and, severed itself from Divine scheme and Shari'ah objectives. (Al-Salamee, 2006, p. 5)

According to Power (2009) many people, including scholars; see the Islamic banking products as mirroring those products available from conventional banks, which makes Islamic banks look a lot like conventional finance in disguise. Power also said that, "Mohammad Akram Nadwi, a prominent Britain based scholar of Islamic jurisprudence, advises his students against taking out Islamic mortgages, because he thinks their structure is merely interest-bearing debt in disguise". Power's view is shared by El-Gamal (2006) that Islamic banks are promoting conventional products as Islamic. El-Gamal (2006) continued to say, "By attempting to replicate the substance of contemporary financial practice using premodern contract forms, Islamic finance has arguably failed to serve the objectives of the Shari'ah".

Meanwhile a financial analyst, Fabrice Amedeo, in his article titled, "Islamic Finance Booming" published in LE FIGARO newspaper has this to say about the modern Islamic banking practices, "Islamic finance can be more of an additional market to the Western banks than it is beneficial to the Muslim economies".(Al-Salamee, 2006, p.6)

In view of the 2008 global economic meltdown, this is what Osman Bakar has to say about the current status of Islamic banking:

> The present global economic crisis has shown the drawbacks of the existing capitalist economic models. There is hope that Islam can now fill the vacuum to provide the solution. But for that to happen, there is a need to look into the fundamental ideas in Islamic heritage that can shape economic thinking. The present Islamic banking and finance cannot provide that fundamental ideas because they have evolved from political, social and economic institutions that are essentially alien to Islam. (A Lecture on Classification of Knowledge in the Context of Islamic economics, delivered at IIUM Kulliyyah of Economics and Management Sciences on 2 April 2009, 2:30 p.m.)

On the other hand, hitherto, the confusion that still looms large about the definition of Islamic banking indicates the loss of sense of direction. Whereas there is a standard definition for conventional banking, there is no clear-cut definition in the case of modern Islamic bank or banking. The conventional banks are technically defined as intermediaries that link up deficit spending units and surplus spending units and, in the process provide the public with a wide range of financial services (Burton and Lombra, 2000, p.267). In the case of Islamic banking, however, there has been a flexible approach to defining such an institution and its business (Bakar, 2002). For example:

> Islamic financial institutions are those that are based, in their objectives and operations, on Koranic principles. They are thus set apart from "conventional" institutions, which have no such preoccupations. (Abdul Gafoor, 2008)

> Islamic banking refers to a system of banking which is consistent with Islamic law and guided by Islamic economics. In particular, Islamic law prohibits the collection of interest, also commonly called riba in Islamic discourse. One form of the argument against interest is that money is not a good and profit should be earned on goods and services only; not on control of money itself. (www.investordictionary.com, 2011)

According to Iqbal (2001), "As a theoretical construct, an Islamic bank, like any other bank, is a company whose main business is to mobilize funds from savers and to supply these funds to businessmen/ entrepreneurs."

> An Islamic bank is an institution with integrated features that can be considered a social, investment and development bank. The Islamic

> bank must be Islamic in its operations. The Islamic bank is expected to foster spiritual values and be a centre of morality. (Al-Hawary, 1981, p. 3)

The variations in the definition of Islamic banking are by themselves clear indications that there is lack of unified direction on the part of Islamic banking.

In conclusion, therefore, the domination of the colonial powers throughout the 19th and 20th centuries left the Ummah mentally and psychologically captive to the conventional system. So all the systems of the Ummah, including banking, has lost the sense of direction from her civilization and heritage as shown by these increasing evidences about the convergence of Islamic banking to the conventional banking system. This state of affairs for sure compels many to raise a fundamental question about the objectives of Islamic banking. Such a question can also have far reaching implications on the activities and performances of Islamic banking as will be discussed in the paragraphs that follow.

In addition to the contentions about the direction of Islamic banking, there are evidences that the performances of Islamic banks have been dismal compared to the performances of the conventional banks. For example, Ahmad al-Najjar, the founder of the first Islamic bank, Mit Ghamr, characterizes the existing Islamic banks as terrible failures (Kuran, 2004). Meanwhile Naqvi (2000) citing (IRTI, 1998) related to a survey of expert opinion on 30 major Islamic banks reveals dismal performance of Islamic banks. Based on the results of the study, it was found that the rate of returns offered by Islamic banks had been generally lower than that of the interest-based banks. The findings attributed this partly due to excessive borrowing in Muslim countries to finance large fiscal deficits, and the large cost of monitoring the profits earned by the bank-financed projects. The study also concluded that cases of loan default had risen dramatically among Islamic banks, which appeared less able to deal with such cases effectively than the interest-based banks. This, according to the researchers, was because Islamic banking had made it relatively easier for rich borrowers to indulge in dishonest behavior at the expense of the not rich depositors. Further evidences from the study showed the incidence of moral hazard problem that posed threats to the fabric of Islamic banking. They claim that this had reduced the capacity of Islamic banks to utilize their funds, leading to excess liquidity and lower profitability. Moreover, the researchers said Islamic banks had generally favored (near) fixed rate of return financial instruments like Murabahah and leasing, which accounted for over 80 percent of their total financing. Hence they concluded that Islamic banks' investment portfolios were typically 'loaded' by trade related activities of shorter duration, as a result of which long-term investments had generally suffered. Other scholars like Mokhtar and Abdullah and (2006) concur with Naqvi's view. In their comparative study of full-fledged Islamic banks, Islamic windows and conventional banks in Malaysia for the period 1997-2003 the authors conclude that full fledged Islamic banks were less efficient than the conventional banks. Samad (2004) conducted a study comparing the efficiency of Bank Islam Malaysia Berhad (BIMB) and conventional banks in Malaysia. His result using ANOVA test showed that conventional banks had higher managerial efficiency than Islamic Bank of Malaysia. A study by Abd el Rahman and Rosly and Mansor and Naziruddin (2003) to investigate the X-efficiency of Islamic banks in Sudan reveals that these banks suffered from technical inefficiency.

Needless to say, Islamic banks are new and may not be as competent as their conventional counter parts. Yet later studies on the performance of Islamic banks also reported the same poor performance on the part of Islamic banks compared to conventional banks. What is visible in most of these literatures is that they have used the conventional techniques and tools of analysis to measure the performances of Islamic banks. Therefore, apparent evidences in most studies using the conventional yardsticks to measure the results of Islamic banks show Islamic banks trailing behind conventional banks. Whether these yardsticks are the correct or fair evaluation criteria to measure the performance of Islamic banks is subject to empirical test. Thus, by using the conventional performance yardsticks, Islamic banking fails miserably.

Critics of Islamic banks on the convergence and the dismal performance, for example Al-Salamee (2006) and El-Gamal (2006), are aware that Islamic banks operate on different principles and philosophies than that of the conventional banks. As such the very objectives of the establishment of the two types of banks are likely to be very different. Although these differences are widely regarded, there has been a notable absence of detail discussion on the subject matter leading to each type of banks' performance measurement. No question has been raised regarding the suitability of using the conventional performance measures to gauge the performance of Islamic banks which have totally different objectives from the conventional banks. Instead, there seems to be a general implicit consensus among writers on Islamic banks that the poor performance of Islamic banks is a true reflection of their situation on the ground. This does bring into fore fundamental research questions. Is the poor performance of Islamic banks due to the mismatch between their objectives and performance criteria or it is really a true reflection of their performance? Is the convergence of Islamic banking towards conventional banking due to the absence of well defined objectives to guide the direction of Islamic banking?

Needless to say, an objective gives a sense of direction. Rather, it raises the why question for which an entity exists, as stated in the Qur'an, "do you think we