SOCIAL AND ECONOMIC DEVELOPMENT PERFORMANCE OF ISLAMIC BANKS: IDEALS AND REALITY

Nora Azureen Abdul Rahman¹ & Nizar Yousef Naim²

¹Associate Professor, School of Economics, Finance, and Banking, College of Business, Universiti Utara Malaysia.
²PhD Student, School of Economics, Finance, and Banking, College of Business, Universiti Utara Malaysia & Lecturer of Accounting and Finance, College of Administrative Sciences, Applied Science University, Kingdom of Bahrain.

ABSTRACT

Social and economic development performance of Islamic banks is a very critical subject that concerns both academics and practitioners in the area of Islamic banking and finance industry. This conceptual paper starts with an overview of historical development of Islamic banks, followed by a review of the topic of social and economic development performance of Islamic banks by looking at the sources of Islamic banking and finance ideals, the regulations related to the issue, the financing modes of Islamic banks and its impact on the social and economic development performance of Islamic banks, and the effect of the current corporate governance practices on the social and economic development performance of Islamic banks. The paper concludes with recommendations for Islamic banks to improve their social and economic development performance in the future.

Keywords: Islamic Banks, Social Performance, Economic Development Performance, Islamic Banking and Finance Ideals, Corporate Governance of Islamic Banks.
PRESTASI PEMBANGUNAN EKONOMI DAN SOSIAL PERBANKAN ISLAM: IDEAL DAN REALITI

ABSTRAK


INTRODUCTION

The issue of social and economic development performance of Islamic banks has been under intense investigation recently and from different point of views. According to Dusuki 2008, Social and economic performance of Islamic banks is considered as important as the financial performance, since Islamic banks besides their responsibility to their shareholders, they have social and economic development responsibilities towards their stakeholders as well. However, the current practice of Islamic banks is centered around the maximization of profit for shareholders, which resulted in a deviation from the social and ethical objectives of Islamic banks (Sairally 2013). In his recent article, Austay (2012), criticised the ‘social failure’ of Islamic banks indicating that their financial performance was in fact on the expenses of their social and economic performance given the fact that Islamic banks have performed financially very well, however, their social and economic development performance is very poor.

Furthermore, in a much wider notion, Cebeci (2012), talked about the concept of "Social Maslahah" that should be adapted by Islamic banks to describe their social and economic development responsibilities, which in his view cannot be described only by social responsibility and corporate social responsibility, because the concept of "Social Maslahah" goes far beyond charity giving to more systematic contribution to the enhancement of the welfare in the community. Cebeci (2012), argued that the failure of the social dimensions of Islamic banks is due to the conversion of Islamic banks into almost entirely Murabahah based Islamic banking. The severe use of debit financing modes over equity financing modes and the limitations of internal corporate governance structure of Islamic banks have resulted in poor social and economic performance of Islamic banks (Austay 2012; Hanif 2016).

This theoretical paper begins with an overview of historical development of Islamic banks, followed by a review the topic of social and economic development performance of Islamic banks by looking at the sources of Islamic banking and finance ideals, the regulations related to the issue, the financing modes of Islamic banks and its impact on the social and economic development performance of Islamic banks, and the effect of the current corporate governance practices on the social and economic development performance of Islamic banks. The paper concludes with recommendations for Islamic banks to improve their social and economic development performance in the future.
LITERATURE REVIEW
This brief literature starts with an overview of historical development of Islamic banks, then a review of the sources of Islamic banking and finance ideals, followed by a short discussion of the different regulations related to social and economic development role of Islamic banks, after that an assessment of equity and debt financing modes of Islamic banks and their effect on the social and economic development performance of Islamic banks, followed by an evaluation of the current corporate governance practices of Islamic banks, and finally a conclusion is presented.

Historical Development of Islamic Banks
The historical development of Islamic Banks can be categorized initially into two stages. The first stage was in the 1960s with the introduction of the first Islamic bank started initially as a social bank in Egypt in 1963 at Mit Ghamer village, many other similar experiences followed that in the 1960s in different countries such as Pakistan and Malaysia "Malaysian Tabung Haji" (El Gamal 2007). The second stage started in the mid 1970s, in 1975 with the establishment of Dubai Islamic Bank which was the start of what is known lately as “Commercial Islamic Banks” (Austay 2012). Nowadays, Islamic banking and finance is a fast growing industry globally, according to Ernst and Young World Islamic Banking Competitiveness Report 2016, Islamic banks assets grew by 16% annually from 490 US$ 2082 Trillion in five years period from 2010 to 2014, moreover, it is expected that the total asset will reach US$ 2.0 trillion by 2020.

The “Commercialization of Islamic Banks” (Austay 2012), refers to the use of debt financing over the equity financing to avoid risk taking, seeking profit maximization, mimicking the conventional banks business model and focusing on the legal form not on the economic substance of the financing modes in Islamic banks (Austay 2012; Hanif 2016). There are a number of reasons that resulted in the commercialization of Islamic banks such as the associations with the conventional monetary system, financialisation of Islamic banks, extreme use of debt financing over asset based financing, neglecting development financing, poor social performance, and weaknesses in corporate governance performance (Austay 2012).

The Sources of Islamic Banking and Finance Ideals
Islamic banking and finance principles are derived from the Islamic economics principles which are originated from the ontology of Islam, the Qur'an, the Sunnah, and based on ‘Magasid al Shari‘a' that is aimed at achieving the 'human well-being' (Austay 2012). In Qur'an there are many verses that indicate the role of a human being in life.

الله تعالى فاعلم ذلك للملائكة إنه خالق في الأرض خليفة (سورة البقرة الآية رقم 30).

Allah in the Qur'an regards humankind as the “vicegerent of Allah on earth” (2:30), "And [mention, O Muhammad], when Alah said to the angels, "Indeed, I will make upon the earth a vicegerent". The "vicegerent status" that is given to humankind on earth by all mighty Alah entitles the humankind to act according to Allah's instruction in every aspect of life including the economic and the financial aspects.

الله تعالى من الأرض واستغتركم فيها (سورة هود الآية رقم 61).

Also in the Qur'an the humankind is instructed by “Alah to inhabitant and develop the earth" (11:61), "He, Adiah, has produced you from the earth and settled you in it". The inhabitance and development of earth as a wider concept that is mentioned in the Qur'an and in relevance to today's world should include, but not limited to, the social and economic developments as a primary facet of the development of the earth as mentioned in the Qur'an.
In the Sunnah also, the Prophet of Islam Muhammad (PBUH) encouraged the Muslim believers to do good for people and for their communities at large, he said, "The best among you, are the best who are best for others".

وَصِيدَ الْعَدُوَّ بِالْعَدَّةِ مَنْ أَكَثَرَ مِنْهُ مُتَوفِيٌّ

And also Prophet Muhammad (PBUH) said describing the relationships between the believers with each other and in their communities "The believer for the believer like a brick pulls each other, and he (PBUH) put his hands together".

"إِنَّ الْمُؤْمِنِ لِلْمُؤْمِنِ كالْهَيْلِ يَشْدِي بَعْضَهُ بِبَعْضٍ، وَيَنْضُرُّ مَعَهُ مَعَهُ فَهُوَ يَشْدِي مَعَهُ مَعَهَ.

With these two concepts from the Sunnah in mid, believers should do good for each other and should be like a bricks in the community pulls each other, in application to the current challenges of life, both the social and economic development can be considered as an essential parts of the common good and the general benefit for the community at large.

Regarding ‘Maqasid al Shari’a’ as one of the foundations of Islamic economics and Islamic banking principles, Chapra (1992), cited in (Hayat and Malik 2014), states that according to the prominent Muslim philosopher Al-Ghazali (died 1111), the objective of the Shari’a is “to promote the wellbeing of all mankind, which lies in safeguarding their faith (din), their human self (nafs), their intellect (ag/), their posterity (nas/), and their wealth (mal). Whatever ensures the safeguarding of these five serves public interest and is desirable” (p. 19).

To this end, and based on the three pillars of Islamic economic philosophy, The Qur’an, The Sunnah, and ‘Magasid al Shari’a’, Islamic banks have an obligation to play an active role in the social and economic development of their communities.

**Regulations on Social and Economic Development Performance**

The major Islamic banking and finance international regulatory bodies, Accounting and Auditing Organization for Islamic Financial Institutions (AAOTFT) and The Islamic Financial Services Board (IFSB) have issued a number of standards and principles to encourage the Islamic Banks to invest in social and economic development in their communities as one of their major stakeholders.

According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which is a not-for-profit organization based in the Kingdom of Bahrain that maintains and promotes Shari'ah standards for Islamic financial institutions, it is recommended that Islamic banks and financial institutions invest in social, development, and environment based investments (Governance Standard No. 7, standard on Corporate Social Responsibility of Islamic banks).

Likewise, the Islamic Financial Services Board (IFSB), which is an international standard-setting organisation based in Malaysia that promotes and enhances the soundness and stability of the Islamic banking financial services industry by issuing global prudential standards and guiding principles for the industry, talks clearly about the responsibility of Islamic Institutions of Financial Services (IIFS) towards its stakeholders in the Corporate Governance Standards. For example, "Principle 1.1 states that IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS’s accountabilities to various stakeholders" (IFSB Corporate Governance Principals, p. 3). In the same standard in relation to Shari'ah principles, it is also stated that; "It is well known that the fiduciary responsibility of IIFS towards their customers includes a primary undertaking by the IIFS to comply with Islamic Shari'ah rules and principles at all times. In line with this unique characteristic of the Islamic financial services industry, the guiding corporate governance principles calls for a "balanced approach by IIFS in seeking to create value for their shareholders while paying due attention to the interests of their other stakeholders" (Standard No. 5 p.8). Furthermore, the guiding principles of corporate governance of Islamic banks indicates strongly the importance of fulfilling the obligations towards their stakeholders, "Accordingly, it is clear that an
IIFS, as a corporate body governed by the principles laid out in Islam, must strictly fulfill its obligations to all stakeholders insofar as it operates within the confines of the Islamic Shariah" (Standard No. 72 p. 16).

The stakeholders of Islamic banks and financial institutions defined by IFSB as "Those with a vested interest in the well-being of an IIFS, including: employees, customers, suppliers, the community (particularly the Muslim Ummah) , supervisors and governments, based on the unique role of IIFS in national and local economies and financial systems" (IFSB Guiding Principles on Corporate Governance, p.27). From this definition of Islamic bank's stakeholders adapted by IFSB, it can be understood that Islamic banks should have social and economic development responsibilities towards not only their communities that they work in but also towards the Muslim Ummah in general. Looking at the above mentioned standards and principles issued by AAOIFI and IFSB, we can conclude that Islamic banks must consider the interest of their stakeholders, mainly their communities that they operate in, when taking an investment and financing decisions which might affect their social and economic development obligations towards their communities.

Social and Economic Development Performance and the Financing Modes of Islamic Banks
For the Islamic banks to be able to achieve its social and economic objectives, they are expected to promote Profit-Loss Sharing (PLS) and equity financing modes such as; "Mudarabah and Musharakah", over the debt financing modes like; "Murabahah" (Faroq 2015). However, in reality only less than 5% of financing modes of Islamic banks are equity based financing "Mudarabah and Musharakah" and 95% of the financing modes of Islamic Banks are debt based financing "Murabahah" (Suzuki & Uddin, 2016). Cebcei (2012), criticized Murabahah contracts indicating that they are disconnected from the real economy and market conditions and eliminating any risk sharing responsibilities of Islamic banks, he concludes that for Islamic banks to be able to fulfill their social and welfare responsibilities toward their communities they should adapt more Mudarabah and Musharakah financing instruments in their banking and financing activities. According to Faroq (2015), Islamic banks and finance should focus on the real economy and circumvent promotion of trade in debt and financialisation, however, the recent data indicates that the modern Islamic banking and finance is heavily biased toward debt based financing modes. In the contrary Mudarabah and Musharakah contracts are tied directly to the real economy and market conditions, they can be applied in big scale joined ventures and complex investments, sharing risks and profits of the business which results in more productivity and more contribution to the well-being of the society (Cebcei, 2012). Based on one of the Islamic finance principals that any claim to a profit must be associated with risk sharing, so ideally profit-loss sharing (PLS) financing modes such as Mudarabah and Musharakah should be emphasized over debt- based financing modes such as Murabahah, however, markedly the Islamic banks favors investment in less risky sectors such as, the real estate sector over the industrial and agricultural sector, moreover, it is mostly financed by debt based financing modes (Faroq, 2015). It is noted that following the path of commercial banks, Islamic banks promote credit cards, which is of course debt based financing, to its customers resulting in promotion of "debt culture" in the community that can negatively affect the credibility of Islamic banks. In the Islamic banking and finance industry there is an insufficient understanding of the consequences of the overuse of debt based financing modes on the economic and social stability of the society which might lead to financial crises similar to that witnessed around the world where banks operate based on the conventional banking systems (Faroq, 2015).

Corporate Governance Structure and the Social and Economic Development of Islamic Banks
The interest of banks governance has received an increased attention from academics and policy makers after the global financial crisis of 2007-2008 (Pathan & Faff, 2013). Financial Corporation’s governance such as banks in general and Islamic banks especially have different organizational context than other nonfinancial corporations. The managers of a bank are responsible for achieving the objective of increasing the wealth of shareholders, while protecting the money of the depositors and creditors. The
mangers of Islamic banks, additionally, are expected to achieve these two objectives and to comply with Sharia' law (Archer, Ahmed & Al Deehani, 1998).

The governance structure of Islamic banks is different from the conventional banks due to the existence of Sharia' Supervisory Board (SSB). SSB is representing a major part of Islamic banks governance structure consisting what is called "Supra Authority" (Choudhury & Hoque, 2006). Accordingly, the governance structure of Islamic banks is a "multi-layer" governance structure, while the governance structure of conventional banks is a "single-layer" governance structure (Mollah & Zaman, 2015).

According to Austay (2012), one of the major reasons for the social and economic development failure of Islamic banks is the shortcomings in corporate governance performance of Islamic banks. Moreover, Safieddine (2009), indicates some governance problems related to audit, control and transparency of corporate governance practices of Islamic banks. It is critically important to develop the corporate governance structures of Islamic banks to avoid any additional problems in the social and economic development performance of Islamic banks.

The cornerstone of any corporate governance system is the composition and structure of the board of directors as they are the main governance body responsible for setting and mentoring the corporate strategy implementation. The Islamic Financial Services Board (IFSB) have encouraged the Islamic Institutions of Financial Services (IIFS) to adapt the best corporate governance practices indicated both in Basel Committee on Banking Supervision (BCBS), Guidelines on Corporate Governance Principles for Banks and The Organisation for Economic Co-operation and Development (OECD) Principles of CorporateGovernances. In IFSB Corporate Governance Principals principle No. 74 it is stated that "in order to avoid “reinventing the wheel” in developing a set of corporate governance best practices for IIFS, the OECD Principles and the BCBS Paper are among the leading references that can provide useful guidelines" (p. 17). Also in principle No. 75 IFSB indicates that "The IFSB shares the governance philosophies subscribed to by the OECD and BCBS, as they can easily accommodate the needs and requirements of different national environments" (p. 17). According to Basel Committee on Banking Supervision, Guidelines on Corporate Governance Principles for Banks (2015), "The board has ultimate responsibility for the bank’s business strategy" (p 8, no. 23). Additionally, The Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance issued in coordination with G20 in 2015, indicates that the board is "Chiefly responsible for guiding corporate strategy" (p 51, The Responsibilities of the Board).

Based on these governance principles, the board of directors of Islamic banks is responsible for setting the overall bank strategy including the financing strategy, the choice of debt vs. equity financing modes, and the social and economic development performance of Islamic banks.

**CONCLUSION**

Based on the literature review of the historical development of Islamic banks, the foundations of Islamic banking and finance principals, the regulation and roles of the international regulatory institutions, and the contemporary issues related to the corporate governance of Islamic banks, it is very clear that Islamic bank should have social and economic development objectives towards their community. However, Islamic banks have not yet achieved their social and economic development ideals.

To be able to achieve their social and economic development principles, Islamic banks should increase equity financing modes such as; Mudarabah and Musharakah, over debt financing modes such as; Murabahah, and develop their corporate governance structures into an optimal governance structure that reflects the interest of Islamic banks stakeholders in order to be able to achieve their social and economic development objectives and fulfill their responsibilities towards their communities.
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