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Exploring the "social failures" of Islamic banks: a historical dialectics analysis

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Abstract

Purpose – This paper aims to argue that the current environment in which the Islamic banking system is situated is not ideal for the system's pursuance of its socioeconomic ideals, thus necessitating the system's shift from pursuing *falah* to maximizing profits.

Design/methodology/approach – The paper theorizes and conceptualizes this shift from *falah* to profit maximization using two complementary theories – systems theory and institutional theory – to prove that such a shift is not unexpected. The paper further adopts a dialectical analysis that is somewhat historical to analyse the shift.

Findings – The measure of the Islamic banks' performance in terms of their social ideals is misplaced, as the environment in which they currently operate does not support such goals. Thus, stemming from the theoretical base, the Islamic banks' pursuance of profit maximization instead of *falah* should not be unexpected. The paper concludes that despite the unfavorable environment, the social ideals of the Islamic banking system may still be met, to an extent, through investment in microfinance and *awqaf*.

Research limitations/implications – The paper adopts document analysis for sourcing data majorly from prior studies. Hence, the authors do not conclude that the analysis herein is applicable to all Islamic banks. Secondly, as the authors could not get a complete historical account of the Islamic banking system's development, some aspects of the dialectical analysis – contradiction and change – have been discussed in a general fashion.

Practical implications – The need for Islamic banks in the current environment, especially for the Muslim population, cannot be over emphasized; however, the achievement of *falah* given this current environment may be daunting.

Originality/value – The current analyses of the shift of Islamic banks from pursuing *falah* to pursuing profit maximization are not well-defined, as they lack a proper theorization of the challenges faced by Islamic banks. This paper fills this gap.

Keywords Isomorphism, Islamic banking, Islam, Capitalism, Dialectical analysis, Falah

Paper type Research paper

1. Introduction

The Islamic banking system was said to have developed as a result of the Muslims' demand for modes of financing that are compatible with their faith (Iqbal, 1997; Aggarwal and Yousef, 2000; Kahf, 2004; Haniffa and Hudaib, 2010). The increasing need for external financing as a requisite for business expansion and catering for personal needs and the failure of the current systems, including capitalism and socialism, are equally some of the factors that led to the birth of the Islamic banking system. As in "capitalism, interest

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promotes callousness and exploitation; in socialism, the suppression of trade breeds tyranny and monstrous disequilibria" (Kuran, 2004, p. 3). Exponents of the Islamic banking system (Siddiqi, 1983, 1985; Ahmad, 1984, 2000; Chapra, 2000a, 2000b; Haron, 2000; Siddiqui, 2001; Rosly and Abu Bakar, 2003; Haron and Hisham, 2003; Naqvi, 2003; Dusuki and Abozaid, 2007; Asutay, 2007), however, opine that the Islamic banking system is free from these ills. If practised, it will bring about distributive justice, equity, fairness and economic growth.

While capitalism pursues wealth maximization, the Islamic system pursues *falah* (success in this world and in the hereafter) (Sarker, 1999; Siddiqui, 2001; Haniffa and Hudaib, 2007; Asutay, 2008). The main point of difference between the two objectives is that the pursuance of wealth maximization in capitalism does not consider societal well-being above self-interest where the two conflict. In Islam, however, societal well-being prevails over self-interest. The decision-making criteria in Islam is to first consider *huququ-Allah* (fulfilling obligations to Allah), then *huququl-ibad* (fulfilling obligations to the society) and *huququ-nafs* (fulfilling own needs) (Haniffa *et al.*, 2005; Abdul-Baki *et al.*, 2013). Through these decision-making criteria, mankind is able to realize benefits for the society via removal of hardship (*raf al-haraj*), prevention of forbidden (*daf al-darar*) and striving for the truth (*haqiqiyah*) before pursuing self-interest (Haniffa *et al.*, 2005, p. 5). It is through this promotion of equality and virtues that *falah* is achieved (Abdalati, 1975). On the other hand, socialism seems to promote societal well-being above self-interest; it falls short of recognizing *huququ-Allah* (Haniffa *et al.*, 2005). Consequently, self-interest is denied beyond reasonable bounds.

Recently, claims of no difference between Islamic banks' operations and their conventional counterparts have been a major point of debate (Warde, 2000; Choudhury, 2007; Kuran, 2004; Kamla, 2009; Haniffa and Hudaib, 2010; Khan, 2010; El-Gamal, 2006; Dar and Presely, 2000; El Hawary *et al.*, 2004; Chong and Liu, 2009; Dusuki and Abozaid, 2007; Asutay, 2007, 2008). It is held that the operations of the Islamic banks are not in line with the stated objectives of the introduction of the system (Asutay, 2008). Indeed, the motives are unequal and the approach to achieving the desired ends differ (Siddiqui, 2001), but this assertion may only be stated to exist in theory and the practice of Islamic banks may be diametrically opposed to their proposed aims and objectives (Kamla, 2009; Chong and Liu, 2009; El Hawary *et al.*, 2004; Kuran, 2004; Khan, 2010; El-Gamal, 2007; Dusuki and Abozaid, 2007; Asutay, 2007).

Islam's emancipatory potentials are neither fallacies nor illusions. If Islam is practiced in its pure form without extremism and unnecessary laxity, then it will achieve its stated socioeconomic ends (Kamla, 2009). According to Haniffa and Hudaib (2010), the initial introduction of the Islamic banking system was met with various challenges; yet it was successful (Ahmad, 2000; Kahf, 2004). However, the shift from this success did not occur without reasons. Several reasons have been identified including claimed mismatch between "ancient solutions" and modern (sophisticated) problems (Kuran, 2004) and questions of whether the practice of and motivations for the Islamic banking system are actually based on piety or other factors (Haniffa and Hudaib, 2010; Pepinsky, 2010 and Kamla, 2009). Notwithstanding, we provide here in that as many reasons may exist for this expectation gap; there is a reality that gives us an insight into answering the question "why?" The Islamic banking is a system existing in an environment that does not share its socioeconomic ideals. Thus, a host of isomorphic pressures (Dimaggio and Powell, 1983) from within its environment necessitates the Islamic banking's evolution into a different system that pursues a different goal from the one envisaged by its exponents.

Although a number of studies have been conducted to provide some insights into the shift of Islamic banks' objective from the pursuit of *falah* to the maximization of profits

(Abdul-Rahman *et al.*, 2014; Cebeci, 2012), a holistic approach that we seek to adopt in this study is lacking in extant literature. Abdul-Rahman *et al.* (2014) has concentrated on the theorization of the failure of profit–loss sharing contracts on which the major Islamic banking transactions should be based. Cebeci (2012), on the other hand, identified some challenges facing Islamic banks from the environment they operate but without theorization. Given these gaps, in this paper, we seek to:

- theorize the shift of Islamic banks from the pursuit of *falah* to profit maximization. Two complementary theories – systems theory and institutional theory – were used to situate our argument;
- conceptualize the shift of Islamic banks from the pursuit of *falah* to profit maximization using institutional isomorphism;
- explain the ideal environment capable of unveiling the inherent potentials of the Islamic banking system using evidences from the Qur'an and Ahadeeth as well as extant literatures; and
- analyze the change of Islamic banks' goal from *falah* to profit maximization through dialectical analysis.

Given this background, the remaining sections are discussed as follows: Section 2 discusses the theoretical as well as the conceptual framework of this study; Section 3 discusses the methodology used in this paper and the analyses that follows from this methodology. The fourth section concludes the paper and makes necessary recommendations.

2. Theoretical and conceptual framework

2.1 Theoretical framework

This study adopts theoretical triangulation (Hopper and Hoque, 2006; Hoque and Hopper, 1997; Hoque *et al.*, 2013) by situating its argument within the confines of two complementary theories – general systems theory and institutional theory. "Theoretical triangulation involves using factors from different theoretical perspectives concurrently to examine the same dimension of a research problem" (Hoque *et al.*, 2013, p. 1175). This approach encourages the adoption of complementariness of different theoretical backgrounds in analyzing and explaining a research problem. It argues (Lukka and Mouritsen, 2002) that the adoption of a single theory may leave interesting issues unexplored because such issues do not fall within the ambit of the chosen theory.

The two complementary theories we have adopted in this study are discussed below, followed by a merger of the two to see how they "talk to each other" (Hoque *et al.*, 2013, p. 1173).

2.1.1 The systems theory. The form of systems theory used in social work – the general systems theory – was originally developed by Bertalanffy (Friedman and Allen, 2011). His idea of systems theory arose from his displeasure with the reductionist orientation – understanding the whole by breaking it into its components – of existing theories (Friedman and Allen, 2011). According to Bertalanffy (1968), the change in and the growth of a system is understood by looking at the system as a whole with its relationship and interactions with the other systems in the environment.

The general system theory holds that a system is an embodiment of sub-systems working together to achieve a particular goal. "A system may be defined as a set of elements standing in interrelation among themselves and with the environment" (Bertalanffy, 1972, p. 417). The theory goes further to explain that like living organisms, changes in one part of the system will affect the other interrelated components and, therefore, the whole system (Bertalanffy, 1972; Kast and Rosenzweig, 1972; Bailey, 2006). Furthermore, "a central notion is that the interrelated internal parts interact overtime (function) in a manner that ensures the survival of the system" (Bailey, 2006, p. 390).

Parsons (1951) augmented the systems theory through a theoretical framework called structural functionalism. The theory holds that a key characteristic of a social system is its function in the larger social environment.

Luhmann's general systems theory is the most developed systems theory (Ritzer, 2012, p. 341), combining elements of structural functionalism and general systems theory. Luhmann's theory holds some major principles that we have used in this study. These principles are subsumed under the term evolution. Evolution comprises three processes – variation, selection and stabilization. Several solutions may exist to curb tensions or pressures from the environment (this is termed variation). A choice is made from these alternative solutions (selection) available, but such solution may not necessarily be the best alternative; it may simply be that the particular solution is the easiest to adopt for the system's stabilization. "Stabilization usually involves a new kind of differentiation that requires the adjustment of all the parts of the system to the new solution" (Ritzer, 2012, p. 341).

2.1.1.1 A system and its environment. A system in relation to its environment is either a closed system or an open system. An open system exchanges information and energy with its environment (Lucey, 2003; Ritzer, 2012; Friedman and Allen, 2011), while closed systems are "isolated from their environment" (Bertalanffy, 1972, p. 39). A social environment is an embodiment of systems that interface with one another. According to Friedman and Allen (2011, p. 6), "there are expectations on the role and functions of the system to conform to standards within the larger social environment". When a system does not abide by the norms of its environment, it becomes dysfunctional. Essentially, a system is characterized by a boundary that is defined in a variety of ways (e.g. customs, ethnicity, physical structure, orientation, etc.) (Bertalanffy, 1972). The boundary of a system is the system's property or structural limitation that delineates it from other systems in the environment. The survival of a system in its environment is dependent on the system's ability to deal with changes in its environment (differentiation) (Luhmann, 1982). Differentiation is the "replication within a system of the difference between a system and its environment" (Luhmann, 1982, p. 230). Thus, a system must maintain its boundary through differentiation "otherwise it would be overwhelmed by the complexity of its environment, breakdown and cease to exist" (Ritzer, 2012, p. 342).

Using the systems theory's explanation above, we can conceive Islamic banks as a system existing in an environment and exchanging information and energy with its environment (i.e. organizations are generally open systems) (Lucey, 2003; Flink and Klimoski, 2004). Through this interaction of Islamic banks with their environment, the process of evolution sets in. This evolution is a process by which the system adapts to changes, pressures and tensions emanating from its environment to ensure survival. The end product of the evolution process is differentiation which is just a stage of stabilization. Thus, the Islamic banking system with the experience of pressure from its environment will need to undergo evolution to survive. The end product of this evolution is the differentiated form of Islamic banks which many studies (Hassan, 1999; Dar and Presley, 2000; Aggarwal and Yousef, 2000; El Hawary *et al.*, 2004; El-Gamal, 2007; Chong and Liu, 2009; Sairally, 2013) have confirmed to be pursuing profits at the expense of their social ideals.

2.1.2 Institutional theory and institutional isomorphism. According to Carpenter and Feroz (2001, p. 565), the institutional theory holds that organizations operate "within a social framework of norms, values and taken-for-granted assumptions about what constitutes appropriate or acceptable economic behaviour". These norms, values and assumptions constitute the institutional pressures in line with which organizations change to gain power, survival and legitimacy (Scott, 1987). This theory moves us to the concept of institutional isomorphism. It refers to the homogeneity of organizations (in their mode of operations and goal) (Dimaggio and Powell, 1983) arising from their operation under the same environment. Organizations need to abide by the norms and values of their environment, as the environment is the same for all; they often become isomorphic to gain legitimacy and power (Dimaggio and Powell, 1983; Carruthers, 1995). According to DiMaggio and Powell (1983), institutional isomorphism can be divided into three – coercive, mimetic and normative isomorphism. Coercive isomorphism arises from changes in organizations as a result of external pressure coming from organizations they depend upon or general cultural expectations (Dimaggio and Powell, 1983; Carruthers, 1995). Mimetic isomorphism arises as a result of uncertainty which forces the organization to look up to benchmarks to adopt what they do (Dimaggio and Powell, 1983; Carruthers, 1995). Finally, normative isomorphism concerns how members of the same profession operate their activities in similar fashion in different organizations (Dimaggio and Powell, 1983; Carruthers, 1995).

In line with the above theory and concept, we contextualize Islamic banks as operating within an environment that does not support the banks' objective – *falah*. Thus, for the Islamic bank to maintain its legitimacy and survival, it will need to change its mode of operation and goal to suite the norm and values of the environment. Hence, they become homogenous to the conventional banks in the environment because of isomorphic pressures from within their environment.

2.1.3 Merging the two theories. We have adopted the systems theory to establish that an Islamic bank is an open system with an environment that is composed of several other systems that the bank communicates with. Because of the tension arising from the bank's objectives and practices being different from that of the other systems within its environment (or the norms, values and taken-for-granted assumptions within its environment in line with the institutional theory), the bank will have to become isomorphic (institutional theory) or evolve (system theory) to ensure its survival or gain legitimacy and power. The process by which the bank ensures its survival and gain legitimacy involves the selection from alternative solutions so as to be stabilized – the bank becomes isomorphic to other banks.

An example of this is how the Islamic banks have widely adopted the *murabaha* over the forms of transactions. The prevailing economic thought in our current environment is capitalism which favours profit above everything. This creates tension with the Islamic bank whose objective is *falah* (Sarker, 1999; Haniffa and Hudaib, 2007; Asutay, 2008). The bank has three alternatives of staying purely Islamic (but may not survive in the long run) or becoming completely conventional or make their Islamic intention have a conventional outlook. Of course, the best position is to completely stay Islamic, but most Islamic banks have opted for the third option to be stabilized and, thus, become isomorphic to the conventional banks.

2.2 Islamic banking and its ideal environment

Islam is a system composed of several interrelated sub-systems working to achieve a common goal – *falah*. Changes in a part automatically affect the other parts and the overall objective in focus. Allah (SWT) explains this conceptualization of Islam as a system in a number of verses in the Quran.

Allah (SWT) says:

> Enter the Religion in totality and follow not the devil (Q2:208).

Hence, taking some parts of the commandments of Allah (SWT) and ignoring some parts does not lead to *falah*. All the dictates of Islam should be followed in all ramifications. In politics, social values, economics and law, Islam should be followed.

Allah (SWT) says again:

> […] […] Then do you believe in a part of the Book and reject the rest? […] […] […] (Q2:85).

The Qur'an further explains that those who will attain *falah* in this world and in the Hereafter are the believers in Allah (SWT) and His Messenger (SAW) (Q16:98; Q61:10-13) and a salient characteristics of these people is that they do not make choices from Allah's (SWT) commandments (Q33:36), rather they follow it wholesomely. Therefore, it follows that an adoption of an Islamic financial system within an overall secular economic system, legal structure and social setting contradicts the above-mentioned commandments and will not lead to *falah*. It is a misconception that an Islamic "thing" can achieve its ultimate aim in a secular set up. While, to an extent, such objectives may be met, the expected success rate may never be achieved:

> Islam cannot accept any mixing with Jahiliyyah[1], either in its concept or in the modes of living which are derived from this concept. Either Islam will remain or Jahiliyyah: Islam cannot accept or agree to a situation which is half-Islam and half-Jahiliyyah (Qutb, 2006, p. 146).

It is a requirement in Islam that all ordainments are followed and part practicing of Islam is not allowed (Q2:85). The environment is secular in its politics, social values, education, economic measures and problem-solving methodologies. Trying to mend the Islamic banking system with these differing orientations will either change its proposed aims and objectives or corrupt it.

Allah (SWT) says:

> "And those who disbelieved, said to their Messengers: "Surely, we shall drive you out of our land, or you shall return to our religion" (Q14:13) and also Q7:88.

The above verse equally points to the fact that in most cases and with a special reference to Islam, a contradiction occurs between an entity and other entities in the same environment when such entity's objective and operation do not align with the norms and values of the environment. Thus, the disbelievers assured the Prophets of their stiff interest to expel them from a land that does not favour their (the Prophets') believe or ultimately revert them back to disbelieve so that they become homogeneous.

According to Haniffa and Hudaib (2010, p. 89):

> Over the years, Islamic finance had to undergo transformation in order to become acceptable as part of the global finance community and in the process, the traditional sacred intentions of fulfilling religious obligations and acting as part of the act of worship became perplexed with the secular goals of modernity.

For ultimate success to be achieved, the integrated sub-systems of a system will have to be based on like with like. Obviously, the general understanding and a well-established fact is that plurality of goals among sub-systems leads to the failure of the overall system in achieving the overall goal. The ensuing situation would be sub-optimization – a situation where the objectives of sub-systems are pursued at the detriment of overall system goals – as each autonomous part of the system attempts to maximize its own objective (Lucey, 2003).

A conceptual model from the above explanations of Islam's systemic nature is presented in Figure 1.

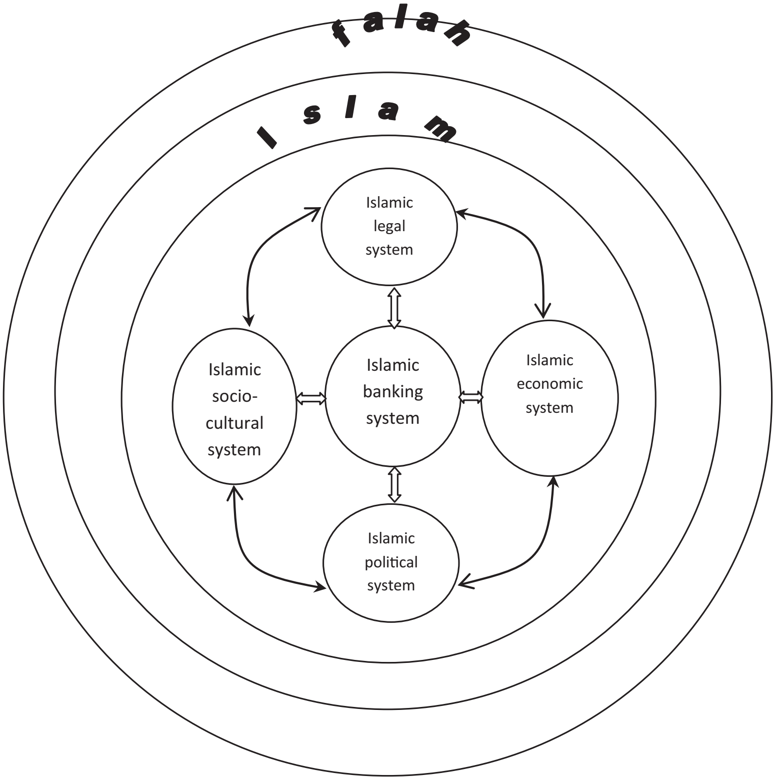


Figure 1.
The ideal environment for Islamic banking

For Islamic banking to achieve its objective – *falah* (Sarker, 1999; Haniffa and Hudaib, 2007; Asutay, 2008), other systems within its environment will need to be Islamic such that only one goal is pursued – *falah*.

We exemplify our assertion – the systemic nature of Islam – here with the research of Khan and Ishaq Bhatti (2006) on the failure of the Islamic banking system in Pakistan. According to Khan and Ishaq Bhatti (2006), the failure of the Islamic banking system in Pakistan is attributable to the limited or differentiated restructuring of Pakistan in line with the *Shariah*. They hold that the Council of Islamic Ideology in Pakistan in 1980 produced a blueprint for an Islamic economic system. According to the CII Report (1983) cited in Khan and Ishaq Bhatti (2006, p. 147), "interest-free economy could not be truly established unless personal and state institutions are also restructured on Islamic lines". More so, in the words of Nomani and Rahnema (1994) cited in Khan and Bhatti (2006), the Islamization process was only adopted in the economic spheres in Pakistan. This differentiated approach to the Islamization of Pakistan, according to Khan and Ishaq Bhatti (2006), has led to the failure of Islamic banking system in the country.

2.3 The contradictions of Islam and capitalism

Islam is a social order (Tinker, 2004) embodying its own principles and premises that are often opposed to the fundamental principles of capitalism. Tinker (2004, p. 452) explains the intrinsic qualities of Islam that clearly contrasts it with capitalism and socialism. He argues thus:

> Islam is a religion that privileges "the innate" moderate and positive qualities of Man, and the importance of knowledge in their development. Material and spiritual life are not bifurcated; they form part of an essential unity. Knowledge is privileged because it fosters human integrity. This knowledge is neither cerebral nor practical, but composed of a holistic relation between belief and behavior, that gives pride of place to a civilized development of humanity. Such notions contrast with priorities of capitalism (to accumulate capital) and Judeo-Christianity (to serve a reified deity).

In Islam, there is no separation between spiritual and material life. Both spiritual and material developments are pursued in unison (Lewis, 2001; Kamla, 2009; Tinker, 2004). In fact, the pursuit of wealth (according to the defined ways in the Qur'an) is integral to the pursuit of an adequate spiritual life:

> But seek with that which Allah has bestowed on you, the home of the Hereafter and forget not your portion of lawful enjoyment in this world; and be generous as Allah has been generous to you, and seek not mischief in the land. Verily, Allah likes not the mischief-makers (Q28:78).

The above-mentioned verse points to the fact that pursuing material development is not an end as avowed by capitalism but rather a means to an end. In Islam, the end is not purely economic; the end here is *falah* and not value or wealth maximization as in capitalism. According to Siddiqui (2001, p. 9):

> *Falah* must not be confused with the term "welfare" current in modern economics. Whereas "welfare" refers mainly to material wellbeing, or at best to all sided wellbeing of this world only, *falah* refers to the good of both the worlds. The period of life after death being a reality, it is but natural that its welfare should be sought for. This concern according to the Islamic viewpoint is not inconsistent with an equal care of this life.
>
> The change from the norm of "welfare" to *falah* implies that achievement of material wellbeing should be in a manner consistent with the achievement of welfare in the more important and internal phase of life- the Hereafter. This implication urges a balancing of interests and exercises a moderating influence both upon individualism and upon the errant quest for material good.

Capitalism, on the other hand, is characterized by the pursuit of material well-being in all conceivable manners. Wealth maximization (in the long run) or profit maximization (in the short run) are the ends in capitalism (Jensen, 2001). According to Friedman (1970), even when capitalist organizations engage in some eleemosynary ventures, the intent is to make such instrumental to earning profits and not to ultimately achieve some social ends. According to Ibrahim (2006, p. 56), the pursuit of profits as an end in capitalism comes with attendant problems like "shortages of demand, weakness of individual interest to achieve public needs, and the discrepancy between private and social costs and benefits (externalities)" which eventually leads to social and environmental damage[2].

The glaring contrast between the objectives of the two opposing social ideologies – Islam and capitalism – as explained above has equally led to a sharp contrast among the instruments used in achieving these objectives. Islamic finance uses *musharaka*, *mudharaba* and *murabaha* as against interest bearing loans, *Ijarah* rather than conventional lease and *Salam* and *Istisna* as against options, futures and derivatives.

Furthermore, Islam and capitalism are not just different in their economic orientations; they equally differ in their social and political realms. In Islam, the Qur'an and the Hadeeth (sayings of, actions of and actions affirmed by the prophet) are the sources of laws and principles that regulate both political and social relationships. Basically, these principles are subsumed under "*Tawheed* (Unity of God), *Khilafah* (vicegerency), *Umma* (community), *Adl* (justice), *Ihsan* (kindness), *Hikma* (wisdom) and *Tawadu* (modesty)" (Kamla *et al.*, 2006, p. 248). We exemplify the implications of these principles for the differing orientations of capitalism and Islam. However, the principles are not discussed in their strict religious interpretations.

Tawheed implies servitude to Allah alone and the absoluteness of His laws across time and space. This means that the Islamic laws are not changeable in response to circumstances except as clearly specified by the Qur'an. It also implies that man is only free to the extents allowable by these laws of Allah. This principle creates a serious contradiction of the norms of capitalist societies where freedom is ascribed to human whims and caprices. For example, the argument often put forward that interest is not the *riba* referred to in the Qur'an is an attempt by the capitalists or their exponents to disguise the modern financial landscape (evolving from modern financial engineering) as lawful for Muslims (El-Gamal, 2003).

Khilafah is man's recognition of his responsibilities and duties as a trustee entrusted with maintaining the balance in the universe within his reach. Such responsibilities and duties are as embedded in the trust deed – Shari'ah. Thus, it encompasses all other principles.

Umma is the recognition that man is a part of the universe and his relationship with the other parts is as dictated by the Shari'ah. Hence, he must be just and kind in dealing with other parts and his kind (*adl and Ihsan*); he must apply wisdom in making decisions that affect others and himself (*hikma*); and he must be modest (*tawadu*) in the consumption and usage of the trust accorded to him.

This mix of principles creates a unique system of accountability that contradicts the capitalist goal of wealth maximization[3]. It creates a system of recognizing the interest of stakeholders that are affected by our actions and inactions (Freeman, 1984) in such a way that best decisions are not those that give us the maximum value or profit, rather best decisions are those that give us the least cost–benefit ratio, where cost include negative externalities (Abdul-Baki *et al.*, 2013).

3. Methodology

3.1 Source of data

In sourcing for data for this study, document analysis was used. Document analysis involves reviewing and evaluating documents to elicit meaning, gain understanding and develop empirical knowledge (Bowen, 2009). According to Bowen (2009, p. 28), documents that can be analyzed include: advertisements; agendas, attendance registers and minutes of meetings; manuals; background papers; books and brochures; diaries and journals; event programs (i.e. printed outlines); letters and memoranda; newspapers (clippings/articles), etc. Data from documents could be in the form of excerpts and quotations (Bowen, 2009). Essentially in historical research, prior study could be the only realistic way of sourcing for data (Merriam, 1988 cited in Bowen, 2009). Thus, as this study is somewhat historical, the preponderance of data (mostly in the form quotations) used have been sourced from prior studies.

3.2 The method of historical dialectics

The method of dialectics was developed by Hegel, but a Marxian interpretation of the analysis has been adopted by most of the researchers (Tinker, 2004; Rodrigues and Craig, 2007; Domenico *et al.*, 2009). The method of dialectics encompasses three basic concepts – thesis, antithesis and synthesis (Rodrigues and Craig, 2007; Domenico *et al.*, 2009). These three concepts, in Marxian interpretation, have been discussed as the principle of totality, contradiction and change (Hopper *et al.*, 1987; Cooper *et al.*, 2005; Wickramasinghe and Alawattage, 2007). Following these scholars (Hopper *et al.*, 1987; Cooper *et al.*, 2005; Wickramasinghe and Alawattage, 2007), we adopt the Marxian interpretation of dialectics in this study. When these principles are applied in historical context, we have the method of "historical dialectics" (Wickramasinghe and Alawattage, 2007,

p. 30). The term principle as used by Cooper *et al.* (2005) and Wickramasinghe and Alawattage (2007, p. 30) imply that each of these concepts cannot provide a dialectical account. They are dialectical when discussed together:

> The principle of totality states that the social world we live in is made up of interrelated elements: various social, political and economic institutions, including organisations and their control systems.

The focal point of the totality principle is the relation that exits amid these elements and not the elements in isolation. The implication of the totality principle is that these elements, because of their interrelatedness, affect one another and a change in one necessitates a change in the others.

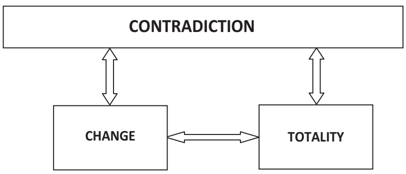
Contradiction occurs when the interest of one element conflicts with the interest of another element or all other elements. Contradiction evokes change.

Change is the corollary of contradictions in the system. It is the result of interrelated cycles of crisis–solution–crisis (Wickramasinghe and Alawattage, 2007, p. 31). Figure 2 below shows the interconnectedness of these principles, as none of them in isolation would solely constitute a dialectic analysis (Cooper *et al.*, 2005).

In the words of Domenico *et al.* (2009, p. 892):

> [...] a core element of the Marxian dialectic is the "law of the negation of the negation" which posits that where there is a collision of two opposites, one opposite negates the other and is in turn negated by higher order historical or social processes which allow aspects of both negated positions to be preserved. This is sometimes represented as the three stages of thesis, antithesis and synthesis in which the dialectic is viewed as a sequence: the parties to [...] conflict relate as thesis and antithesis and resolve into the form of synthesis, which not only subsumes aspects of both thesis and antithesis but creates new patterns or structures.

In this study, Islamic banking system is conceptualized as existing in a system consisting of interrelated political, economic and social events and structures (totality), and the change in these events and structures (emanating from isomorphic pressures from within the environment) inadvertently led to a contradiction between the Islamic banking system's objective and the objective of the capitalist environment. For the Islamic banking system to survive and its actions legitimized (see institutional theory), it had to evolve (see systems theory) from its initial pure Islamic form where *falah* was pursued to its current state of differentiation (see systems theory) where *falah* has been overshadowed by profit maximization which is the prevailing feature of the current social ideology (Haniffa and Hudaib, 2010; El-Gamal, 2007; Asutay, 2007). We render this account of the shift of the Islamic banking system from pursuing *falah* to maximizing profit by locating some period in history when Islamic banks' pursuance of *falah* could be understood by the banks' relationship with events, structures and elements that were existing in the system's environment (totality). We move further to discuss how changes in these events and



Source: Wickramasinghe and Alawattage (2007)

Figure 2.
Elements of dialectical analysis

structures (contradiction) forced Islamic banks to evolve and become differentiated (change) in the quest for survival and legitimacy.

3.2.1 The historical dialectics of the Islamic banking system. The initial introduction of the Islamic banking system started with contradiction. According to Mahomedy (2013), Islamic banking system was not conspicuously identified as a distinct philosophical system. It was a part of integrated whole of the Islamic social, political and economic system. This view is consistent with the view of Kahf (2004). Contradiction occurred when the colonialist left the Muslim countries with an economic system that was "alien and inimical to the culture of Islam" (Mahomedy, 2013, p. 557). Thus, the Islamic banking system was a manifestation of the change arising from the aforementioned contradiction between the socioeconomic system (that was a part of the integrated whole) observed by the Muslim countries and the capitalist philosophy of the colonial masters.

Given this background, we analyze the historical dialectics under three main headings – totality, contradiction (isomorphic pressure) and change – how the Islamic banking system's objective became diluted with capitalist ideologies.

3.2.2 The totality. Totality exists when the integrated components are supportive and not contradictory. In this context of the Islamic banking system, totality exists when the social system, political and legal system are supportive of the economic system – Islamic banking system. Change only occurs when there is contradiction in the interest of these interrelated parts.

The modern Islamic banking system started with the Tabung Hajji – Pilgrims' Administration and Fund in 1956 in Malaysia (Kahf, 2004; Haniffa and Hudaib, 2010; Ariff, 1988). This fund was established with the aim of accepting savings for Hajj which were equally invested according to the dictates of the Shari'ah in "real estate, industrial and agricultural sectors" (Kahf, 2004, p. 18). The Tabung Hajji was supported by legislative backups as all the Malay population were required to process their hajj papers through the fund (Kahf, 2004). Not only that the fund had government backing, the whole idea of Hajj financing was captivating to the poor Malay population. The ability of the fund to increase its share in real estate, industrial and agricultural sector was enhanced by the increasing savings channeled to the fund by the Malay population not only for hajj but also for investment purposes.

The MitGhamr experiment in northern Egypt in 1963 was the second attempt to assess the practicability of the Islamic banking system. This experiment did not last long, as the savings/investment houses (MitGhamr) were closed down by the government in 1967 (Ready, 1981; Ariff, 1988). However, according to Khaf (2004, p. 19):

> […] the success of the MitGhamr experiment was in its ability to spread from one small town to another to induce more savings among lowest income strata of Egyptian society and to create and encourage small entrepreneurs.

Subsequent to the closure of the MitGahmr, the Egyptian government created the Nasser Social Bank (NSB) in 1971. This bank was government-supported and was based on the interest-free financing mode "although its charter made no reference to Islam or *Shariah* (Islamic law)" (Ariff, 1988, p. 48). The bank was equally accepting Zakah, and all public sector establishments were to pay 2.5 per cent of their profit (in the form of tax) to the bank for its capital and reserve accumulation. According to Kahf (2004, p. 20):

> […] the NSB plays an important role in financing small entrepreneurs and in serving low income, usually religious families with both its *riba*-free financing as well as the activity of its huge Zakat department.

From mid 1970s to 1990, the Islamic finance entered a new phase brought about by the changing oil prices, pan Islamism and pan Arabism (Warde, 2010; Haniffa and Hudaib, 2010). However, under the guise of pan Islamism (unifying the *ummah* by King Faisal of Saudi Arabia), the Islamic Development Bank (IDB) was created by the head of states of Saudi Arabia, Somalia and Algeria (Haniffa and Hudaib, 2010) "to serve as a buffer institution for the distribution of financial aid from the Muslim oil exporting countries to their brethren in Africa and Asia" (Kahf, 2004, p. 20). This bank was to also cater for large financing needs of imports and domestic trade and credit (Haniffa and Hudaib, 2010) brought about by the "rise in national earnings of oil exports" (Kahf, 2004, p. 20). This development was soon followed by the establishment of other large-scale banks like Dubai bank in 1974 (the first commercial Islamic bank). It is noteworthy here to say that the IDB was not established as an Islamic bank but as a bank of the *Umma* (to cater for the Muslims' needs) (Kahf, 2004; Wilson, 1989).

It is reasonable at this juncture to clarify that all these banks created to this point have been able to sustain their objectives (majorly social) because of support from other components of the integrated whole. The governments have backed these establishments (political support), the people have welcomed the idea (social support) and the legal systems have permitted a smooth operation of the banks (legal support). Contradiction sets in and a change follows when the interest of these components changes. The next section discusses these contradictions.

3.2.3 The contradictions. It is obviously difficult to establish emphatically a point in time when the contradiction between the interests of these integrated components began. Change occurs when contradiction has brought about crisis–solution–crisis. According to Haniffa and Hudaib (2010), the early establishment of the Islamic banking system was not with its attendant hostilities. They noted that the establishment of some of the early Islamic banks (as known today), such as Dubai Islamic Bank, Jordan Islamic Bank, Kuwait Financial House and Islamic Bank Malaysia Bhd, were by bankers that had little knowledge of the Shari'ah financing but had experience in the conventional banking system. Therefore:

> […] since new legislations are needed for establishing the banks based on Shari'ah, they face complications not only due to most of the newly independent Muslim countries adopting the secularized law left by their colonizers but also deciding on which madhab (Islamic school of thought) to form the basis of their legislation.

Thus, this shows an existing contradiction from the legal systems of the Muslims countries before the establishment of the Islamic banking system. The manifestation of this contradiction can be vividly observed by the compulsion enforced upon many Islamic banks to prepare financial reports in accordance with their national accounting standards or the International Accounting Standards (IAS now IFRS) and not the standards that are compatible with the Islamic finance transactions as issued by the AAOIFI (Karim, 2001). The standards issued by the AAOIFI are primarily designed for the Islamic banks' business transactions as "these standards specifically cater for the unique characteristics of the contracts that govern the operations of Islamic banks" (Karim, 2001, p. 169).

Another contradiction (social contradiction) occurred when the Mufti of Al Azhar – Sheikh Tantawi – declared interest bearing transactions halal (lawful) in 1989 (El-Gamal, 2007; Haniffa and Hudaib, 2010). According to Haniffa and Hudaib (2010, p. 88), "this fatwa provided Islamic banks more bargaining power to expand globally". In furtherance, Haniffa and Hudaib argued that:

> There also exist another group of neo-liberal Muslim entrepreneurs or Muslim bourgeois who were more interested in enhancing their economic and political reputation under the guise of Islamic solidarity. Such individuals managed to charm and captivate the common minds in accepting their reasoning and practices although at times pushing the boundaries of shari'ah. Their motive in interacting with *fiqh*

> scholars was to get their endorsement in liberalising the industry. Their attempt bears fruit with the fatwa from Sheikh Tantawi. Hence, this period marks the start when sacred intentions became mixed with secular goals facilitated by the alliance with highly respected Shari'ah scholars (p. 88).

A further contradiction culminating into change was also observed in the area of deregulation of financial product which, according to Haniffa and Hudaib (2010, p. 89), was a corollary to the new world-order policies which has led to:

> […] greater alliance between bankers, government and Shari'ah scholars [that] facilitate the innovation of Shari'ah -compliant products as opposed to Shari'ah based products.

In a more general sense, Cebeci (2012, p. 170) analyzed the contradictions that led to change in the socioeconomic objective of the Islamic banking system into two broad categories – internal and external factors. The external factors are related to the fact that the Islamic banks have to exist in a capitalist world "that are largely shaped by capitalist mindset". The existence of Islamic banks outside the realm of this institutional framework is not currently achievable "because they lack sufficient economic and political power to shape the public opinion and create an institutional context compatible with Islamic finance" (p. 170). Further, on the cultural context of the Islamic banks' current environment, Cebeci (2012) opines that Islamic banks do not have a good customer base that is willing to abandon some practices in the capitalist system which they are accustomed to. For example, the depositing of money for an interest as a fixed return without bearing any risk. This argument is buttressed with the study of Pepinsky (2013). He finds that Indonesian Muslims' demand for Islamic finance product is positively related to family income and perception about establishing a strong political connection with Saudi Arabia but not piety.

Cebeci (2012) explains further that stemming from the institutional barriers, the Islamic banks have to operate under hostile political and legal constraints. "For example, Turkish Law (no. 5411, article 48) considers [the] funding the "Islamic" banks provide for procurement of commodities as "credit" (Cebeci, 2012, p. 171). Similarly, he explained further that for:

> […] savings account there is a potential conflict between UK law, which requires capital certainty, and Sharia law, which requires the customer to accept the risk of a loss in order to have the possibility of a return.

Internal factors according to Cebeci (2012) are those arising from the use of capitalist entities and philosophies as the ideal benchmark by Islamic banks in all areas of operation including: decision-making standards, recruitment and managerial controls, all of which have turned Islamic banks to quasi-capitalist entities (Kamla, 2009). A manifestation of this claim is apparent in the use of *Murabaha* transactions by Islamic banks rather than their traditional *Mudharaba*- and *Musharaka*-based financial transactions that adopt the profit- and loss-sharing model (Dar and Presely, 2000; Warde, 2000; El Hawary *et al.*, 2004; Benamraoui, 2008; Kamla, 2009).

All these contradictions detailed above have changed the socioeconomic objective (*falah*) of the Islamic banks to the capitalist ideology of profit maximization. Hence, rather than the pursuance of an all-rounded societal well-being, Islamic banks have resorted to pursuing majorly profits. A conceptual model from the above is presented below in Figure 3.

3.2.4 The change. A typical pointer to the change in the motives of Islamic banks from a social dimension to profit maximization is the prevalence of the non-participatory form of financing which constitute up to 80 per cent of the asset portfolio of Islamic banks (El Hawary *et al.*, 2004). Dar and Presely (2000) are also of the opinion that less than 20 per cent of the Islamic banks operate their traditional profit- and loss-sharing (PLS) financing mode.

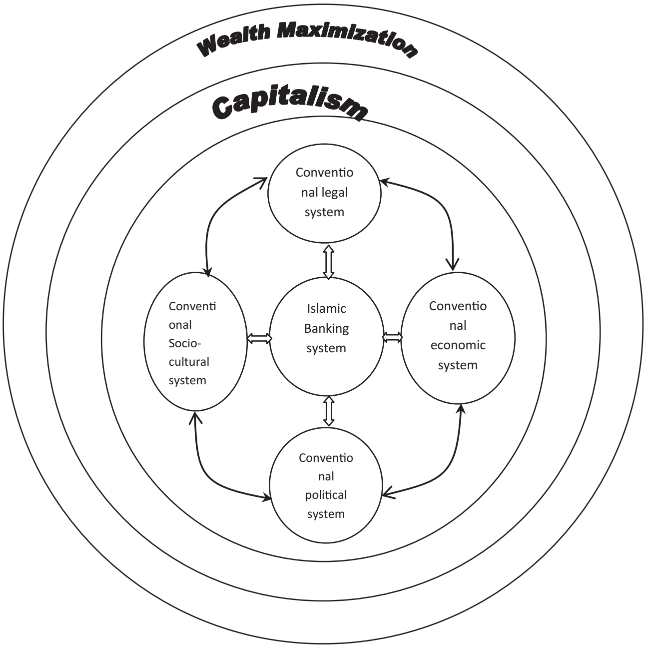


Figure 3.
The current Islamic banking environment

According to Khan (2010), 91 per cent of the Islamic development bank's portfolio between 1976 and 2004 was not PLS-based. He explained further that between 2006 and 2007, 92 per cent of the income of the IDB was still derived from non-PLS transactions. Table I below details the percentage of the non-PLS financing modes to total assets of some major Islamic banks.

Khan (2010, p. 811), in concluding why Islamic banks still rely on the non-PLS, asserts that these short-term financing modes are still interest-based and it is "only no longer explicitly identified as interest-based finance and that the business is no longer dominated by non-Muslims". According to El-Gamal (2006), these modes of financing are basically a replica of the conventional banks' products in practical terms (Chong and Liu, 2009). The dominance of the non-PLS mode of financing by Islamic banks according to Khan (2010, p. 812) is because of information asymmetry that results to moral hazards and adverse selection:

Islamic banks	% of non-PLS financing mode to total assets (2006)	% of non-PLS financing mode to total assets (2005)
Al Rajhi Bank	99.5	99.7
Kuwait Finance House	76.4	73.1
Dubai Islamic Bank	70.4	69.6
Bank Islam Malaysia	92.8	98.9
Meezan Bank	77.3	79.9
Al Baraka Islamic Bank	85.6	98.7
Faysal Bank	89.3	89.6

Source: Khan (2010)

Table I.
Reliance on *Murabaha* and *Ijara* (leasing) by Islamic banks

> Naturally, the degree of information asymmetry, and the resulting adverse selection and moral hazard problems, depends upon the amount and quality of information flows between lender or investor and borrower. Institutions such as credit-rating bureaus improve the information flow and reduce the likelihood of adverse selection, while civil, criminal and possibly societal sanctions reduce the moral hazard dangers. However, in the absence of institutions to mitigate the information asymmetry issue, fully collateralized debt-finance would be the financing mode preferred by banks to minimize their risk.

Hassan (1999) is equally of a similar opinion as Khan (2010). He opines that:

> On a theoretical level, equity contracts can be optimal financial instruments when contracts are incomplete with respect to cash flows, but the optimality and use of equity contracts will decrease as the level of agency problems and adverse selection increases within an economy. The paucity of long-term financing and abundance of short-term *murabaha* type are rational responses on the part of Islamic banks to informational asymmetries in the economic environments in which they operate. The Islamic banks can, however, provide long-term project financing in economies where adverse selection and moral hazard problems are minimal (p. 60).

Furthermore, Aggarwal and Yousef (2000) conclude from their modeling of contracts that can be offered by Islamic banks (i.e. PLS and non-PLS) that the dominant use of non-PLS contracts by Islamic banks is a rational response to the agency problems in their operating environment. They affirm that as agency problems persist, debt becomes the prevalent choice of finance. Hence, they submit that as Islamic banks are influenced by the environment in which they operate, as they equally seek to maximize profits, it is unlikely that religious norms will change human behavior to enhance the Islamic banks' achievement of their social goals. Azmat *et al.* (2015) argue further that the dominance of *murabaha* in Islamic banks cannot be completely explained by information asymmetry alone. They submit that in addition to information asymmetry, risk-averse attitude of bank depositors is equally an important explanatory variable. Shaban *et al.* (2014) conducted a comparative study of banks' lending attitude to small businesses between Islamic and non-Islamic banks in Indonesia. They found that Islamic banks generally lend to small businesses than their conventional counterparts. However, they noted that the lending was driven by profitability and was done through *murabaha*, given its less risky structure.

It can be concluded from the above that the adoption of non-PLS modes of financing by Islamic banks is a function of information asymmetry arising from agency problems and risk-averse depositors, both of which are factors prevalent in the current capitalist environment. Thus, testifying further to the contradiction between the socioeconomic objective of Islamic banks and the environment in which they operate ultimately leading to a change in the Islamic banks' operation (i.e. the adoption of short-term interest-based financing modes rather than PLS models).

Change pointers are not limited to the facts above; numerous empirical conclusions have in the same vein attested to the divergence of the Islamic banks from their social objectives that they avow. Sairally (2013, p. 238) conducted a survey of 46 Islamic banks worldwide to examine their perception of the place of CSR in the hierarchy of objectives, using content analysis and an analysis of the responses to the mail questionnaire, she submitted that:

> Most of the IIFS were observed to be focused on meeting their legal, economic and Shari'ah responsibilities, that is, were concerned with the goals of profit maximisation and for their transactions to meet Shari'ah compliance. CSR was practised as a peripheral activity by the IIFS as opposed to being an integral, well thought-out and deliberate policy decision of management.

Futhermore, Akbar *et al.* (2012, p. 353), through a mail questionnaire, surveyed Islamic banks customers' perception of the practices of Islamic banks in the UK. They conclude that users' responses indicate that "Islamic banking in the UK is not fully aligned with the paradigm version of Islamic finance". Al-Ajmi *et al.* (2011) examined the investment appraisal technique adopted by Islamic banks in Bahrain. They found that IRR is the most common technique adopted by Islamic banks and traditional methods of measuring cost of capital like CAPM were also adopted by Islamic banks. This contradicts the Islamic *shariah* as supported by some Islamic economists. Equally, according to Abdul-Baki *et al.* (2013), even when the traditional methods of investment appraisals are deemed acceptable, the overall ranking criteria for investment evaluation by Islamic banks should be the least cost–benefit ratio, where cost includes negative externalities. Chong and Liu (2009) also observed, using a granger causality test, that Islamic deposits are not interest free; rather, they are closely related to conventional deposits. Kamla and Rammal (2013, p. 911) conducted a content analysis of annual reports and websites of 19 Islamic banks. They submitted that despite the claims by these Islamic banks of having a social inclination than their conventional counterparts, their reports "lack specific or detailed information regarding schemes or initiatives *vis-à-vis* poverty eradication or enhancing social justice". Finally, Rashid *et al.* (2013, p. 359) investigated the dimension of corporate social responsibility of Islamic banks regarding their inclination towards efficiency and customer satisfaction and the *Shariah*. Using content analysis of 16 Islamic banks across Bangladesh, Malaysia and the Arabian Gulf Region, they found that Islamic banks are "too customer-centric and efficiency driven", and this is done at the expense of the *Shariah*.

4. Conclusion and recommendations

The Islamic banks' shift from pursuing *falah* to maximizing profit can only be understood when Islamic banks' relationship with the socio-political and legal structure in their environment is scrupulously examined. The history of the experimental stage of the Islamic banks' development has testified to this standpoint. The MitGhamar and Tabung Hajji were able to pursue *falah* because the socio-political, legal and economic structures of their environment were supportive of them. Colonization of the Islamic world brought about different structures that were contradictory to the existing Islamic structures. Hence, for the Islamic banks to survive and their activities to be legitimized, they have to define their practices in a way that conforms to the norms of the environment they now exist in. Otherwise, they become overwhelmed by their environment and cease to exist (Ritzer, 2012).

Ul-Haq (2012, p. 60) observed that "the bank is not a stand-alone institution, it operates in a climate of 'secular living', which at its core, is consumerist and often criticised for being exploitative". In the same vein, Islamic banks are not stand-alone institutions; they exist alongside other systems in the same environment that, unfortunately, do not share their goals and objectives. Islam provides an alternative that is not comparable by any means with any philosophy of life. Capitalism and socialism are not alternatives to an Islamic system, and they cannot co-exist. We either have Islam in its pure form or just socialism and capitalism. An attempt to merge the two will lead to a change in either and such change is achieved by the rival that possesses a greater force or commands a greater support. In this case, capitalism owns such forces and has changed the socioeconomic objective the Islamic banks claim to be pursuing to profit maximization.

Given these, we can come to the conclusion that the evaluation of the Islamic banks' performance in terms of its social goals is only appropriate when the Islamic banking system exists in a true Islamic setting, and it is not affected by the isomorphic pressures from the environment. The achievement of Islamic banks' social ends, as it is usually claimed, is only achievable when the whole system is Islamic (i.e. all contributing sub-systems to such social ends are Islamic), as this is the only time when all systems in the environment share a similar goal – *falah*. However, considering the seemingly formidable network of secular obstacles, an Islamization or Islamication (Ul-Haq, 2012) of all these sub-systems currently seems unachievable. Thus, a temporary measure to ensure the Islamic banks' achievement of their social ends is to invest greatly in the Islamic microfinance sector.

According to El-Gamal (2007):

> […] the earliest Islamic banking experiments in India and Egypt were small rural co-operatives inspired by European mutual. They focused on economic development, poverty alleviation, and fostering a culture of thrift among poor Muslims. The true hires of this tradition today appear to be microfinance institutions not the multinational banks championing Islamic finance.

Hence, one could capture from this assertion of El-Gamal (2007) that the achievement of the stated Islamic banks' social ends can be pursued through Islamic microfinance institutions. Currently, such institutions are under-invested in. In all, 72 per cent of people living in Muslim-majority countries do not use formal financial services.

> According to the study released by the consultative group to assist the poor (CGAP), the estimated size of Islamic microfinance today is $628 million in managed assets as at 2011, which is 0.8 per cent of the estimated total global microfinance market of $78 billion (Reuters, 2013, p. 59).

Investment in microfinance activities will go a long way in Islamic banks' pursuit of their expected social ends in these current environmental conditions. However, Islamic banks currently face many challenges, and adding up microfinance activities will imply an additional risk. Nonetheless, according to Dusuki (2008, p. 49), reducing the risk of microfinance practices goes beyond traditional financial intermediary role. He advised that to reduce the risk – financial risk and transactions cost – emanating from our current environment conditions, "building human capacity through social intermediation and designing group-based lending programmes" will reduce the risk Islamic banks may be exposed to. He further advised that the use of special purpose vehicles can protect Islamic banks from associated risks of micro-financing.

A second option is for Islamic banks to invest in the *awqaf*:

> Waqf is the locking up of the title of an owned asset from disposition and allotment of its benefits for specific purpose or purposes. A waqf asset cannot be disposed of; its ownership cannot be transferred. Only its benefits are to be used for the specific purposes which are mainly charitable in nature (Sadeq, 2002, p. 139).

Waqf has played important roles in reducing poverty in history through its charitable ends (Sadeq, 2002; Ahmed, 2007), and this will present a spectacular avenue for Islamic banks to showcase their commitments to their social objectives if widely adopted.

Notes

1. Jahiliyyah describes a situation of unawareness of the laws of Allah (SWT) or a situation where such laws are known but are not followed.
2. See for example, Boyce (2009), for a case study of how a firm has prioritized profit over consequent environmental harms in making an investment decision. Also see Hassan and Kouhy (2013) and Orubu *et al.* (2004) on how petroleum companies in Nigeria flare gas, partly as a result of the cost of converting it into usable form being greater than the benefits therefrom and not minding the environmental and human damage caused by gas flared.

3. See for example, Boyce (2009), for a case study of how a firm has prioritized profit over consequent environmental harms in making an investment decision.

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