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Moving Forward Islamic Finance: A Reflection on the Approach and Direction

By
Hafas Furqani[*]
Zaki Fuad Khalil
Abdul Hamid

Abstract

The immense development of Islamic banking and finance in the last three decades has moved the industry into global integration in the international financial market. From a local system of finance with limited assets and market shares, Islamic banking and finance now emerges as a multinational industry. The people of the world do not only welcome Islamic banking and finance, but also put their hopes that it can provide alternatives to the mainstream financial practices and also provide solutions to the problems and crisis which regularly occur in that system. While the outlook seems to be very positive, some, however, question whether the development is moving on the right track to realise the hopes pinned on it at the time of its initial establishment. Whether Islamic finance really provides alternative to the conventional finance paradigm and whether the approach taken in developing Islamic finance is appropriate are the questions that emerge currently. There is a wide expectation that Islamic banking and finance is able to provide the guidelines for managing a good economy, stimulating growth and development, realising socio-economic justice and promoting employment and stability. Islamic banking and finance therefore should not limit itself to merely offering economic and financial practices that satisfy the minimum standard of legal requirements.

Keywords: *Islamic banking and finance, legalistic approach, systemic approach, foundations, meaningful development*

1. Introduction

Islamic banking and finance which emerged in the last four decades has developed immensely and has gained global acceptance. Islamic banking had its debut in 1970's,

[*] Authors: Dr. HafasFurqani is Lecturer, Department of Economics, Ar-Raniry State Islamic University, Banda Aceh, Indonesia. His email address is hafasf@gmail.com.

ZakiFuad Khalil is Lecturer, Faculty of Islamic Economics and Business, Ar-Raniry State Islamic University, Banda Aceh, Indonesia

Abdul Hamid is Lecturer, Department of Syariah Banking, Zawiyah Cot Kala State Institute for Islamic Studies, Langsa, Indonesia

when the Islamic Development Bank as a multilateral development financing institution and the Dubai Islamic Bank (first Islamic commercial bank) were established mandated to operate in adherence to *Shari'ah* rules and principles. Islamic banking has made significant progress worldwide, particularly in South-East Asia, the GCC region, the Middle East and South Asia. Currently, Islamic banking and finance has grown to more than 600 Islamic banks and 90 *takaful* companies in over 75 countries managing US$1 trillion in assets with a growth rate of 15-20 per cent per annum.

Many view today's fantastic development as a seamless continuation of the three earlier decades (1970s–1990s) of Islamic finance's development, in which scholars and practitioners laid its philosophical and conceptual foundations. The dramatic expansion might be seen as a success story which shows the world that Islam and the Shari'ah can contribute positively to solving modern finance needs. It is one the main practical manifestations of the Islamic worldview in the field of economics and finance as well as one of the most visible features of Islamic revivalism in the latter part of the twentieth century.

Some, however, do not view the impressive development in a relatively short period of time as a natural progression from the pioneering stage. Many questions have been raised about the Islamicity and genuineness of Islamic finance and the nature of its progress. Those observations and critics should not be underestimated if we want to have real Islamic economics, banking and finance that can be sustainably developed in the future. For that reason, reflection on the development and direction of Islamic finance should be an on-going practice. This paper attempts to observe the development of Islamic finance by looking at the *raison d'être* of their emergence and the approaches in its development. Subsequently, the directional trends of development and their future outlook will be outlined.

2. Developing Islamic Finance: Understanding The Approaches

The idea to develop Islamic finance has been initiated since 1890s when Barclays Bank started its Cairo branch to process the financial transactions related to the construction of the Suez Canal. This was the first commercial bank established in the Muslim world. Muslim scholars at that time have initiated the critique of bank interest as *riba*. Shaikh Muhammad Abduh as well as Muhammad Rashid Rida has opinions on the issue (Shinsuke, 2012).

During 1900–1950 The critique also spread to other Arab regions, and to Indian sub-continent. In this debate, a majority of scholars subscribed to the position that interest in all its forms constitutes the prohibited *riba*. Intellectual effort has also been put to offer theoretical models of banking and finance that are Shari'ah compliant as a substitute for interest-based banking (IRTI, 2005).

In the 1960s, the effort to put banking and finance based on Islamic principles in practice began in Egypt and Malaysia. In 1963, an Egyptian banker named Ahmad al-Najjar opened a tiny savings bank based on profit sharing instead of lending in the town of MitGhamr. The bank is not called Islamic bank yet since the Nasser government frowned on anything that smacked of Islamism. In 1962, Malaysia established Tabung Haji Malaysia as an institution offering Islamic financial services (IFS) and manages the pilgrimage to Makkah for Haj. Tabung Haji has since flourished and has become the oldest Islamic financial institution in modern times. During 1960's the operational mechanisms for institutions offering Islamic financial services began to be proposed and a number of books/articles has been published as an intellectual back-up on the viability of Islamic banking based on profit and loss sharing and leasing.[4]

Observing the trend, Saeed (2004: 114) identifies two different *raisons d'être* for the emergence of Islamic finance in the late twentieth century which subsequently affected the approach to developing it. The traditional position propagates the 'idealistic' approach bound by the actual practice of the past; others look to a more 'liberal' approach that is pragmatic in nature, one that keeps an eye on the past while emphasizing current needs and aspirations. The idealistic approach aims to develop Islamic financial system as a distinct one in an Islamic economic system with a significant different perspective and approach to the conventional economic and financial system.

Saeed (2004) however observes that the 'pragmatic' approach has gained wide acceptance lately. The present practice in the context of a worldwide financial system is to adjust the interpretation of financial principles in Islamic law to accommodate and provide the same type of services and investment mechanisms as the dominant system. The pragmatic approach emphasises flexibility in interpreting Shari'ah texts to keep pace with the global economic and financial environment. This approach has facilitated the development of a viable Islamic finance sector in the modern economic landscape.

Anwar (2002: 4) and Nyaze (2007: 128), however, contend that pragmatic approach in developing Islamic finance is not genuine and, hence, offers practical models that falls within the ambit of *riba*. The shortcoming comes from an inadequate understanding of *riba* in the modern context. This allows flexibility and discretion in proposing banking instruments and transactions but with uncertainty as to legal validity, whether they really conform with the Shari'ah or its spirit (*maqasidal-Shari'ah*).

In our observation, we found that the phenomenon of the emergence of Islamic finance to be triggered by 'legalistic' and 'systemic' drivers. We see the approach taken in developing IBF instruments and contracts as reflecting these two main drivers, and we could say that its future progress is based upon them.

First, the emergence and establishment of Islamic banking and finance has been basically pushed by the desire to have a 'legal' (*halal*) form of financial services. The purpose in this regard is to cleanse economic and financial practices from interest (*riba*), gambling (*maysir*), uncertainty (*gharar*) and other prohibited(*haram*) elements commonly found in financial services.

Central in this perspective is the view that interest is the *riba* that is prohibited in Islamic law; the meaning of *riba* is soon reduced to mean 'interest'. Therefore, we see in practice, as well as in the literature, a pragmatic objective to have 'interest-free' banking and finance. The viewed is adopted in the mainstream approach of Islamization of banking and finance. This understanding of the prohibition of *riba* as a legal issue restricted to interest and less an economic or ethical problem or even a systemic and civilizational problem has resulted in a pragmatic approach being taken in developing IBF by retaining a conventional banking and finance structure with all its ramifications except interest. For that reason, El-Gamal (2006: 8) describes Islamic finance as a

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[4] See Siddiqi (1981), for a comprehensive survey of literature on Islamic economics, banking and finance.

"prohibition-driven industry" whereby "Islamic finance is not constructively built from classical jurisprudence, rather, Islamic alternatives or modifications of conventional practice are sought whenever the latter is deemed forbidden." Iqbal and Mirakhor (2007: 1) describe this as a piecemeal approach that tends to view different aspects of the system as totalities and might create further confusion at the conceptual and practical levels.

Second, Islamic finance emerged with the purpose of arranging economic life in an Islamic way. There was a consciousness amongst contemporary Muslims of the need to rearrange everyday socio-economic aspects of life in line with Islam's injunctions and within the overall framework and system of Islam as well as to provide indigenous solutions to the problems of the Ummah.

The emergence of Islamic finance is viewed as a 'systemic' response to the crisis of a capitalist financial system by restructuring the financial and banking system of the world on alternate foundations. The Islamic financial system is expected to respond to the present adverse situation of the world and its unfair financial system, which is exploitative, discriminatory and unjust in its allocation of resources. It is structured to systematically transfer wealth from poor people to rich people and from poor countries to rich countries. It is also unstable, having fragile foundations that lead to bubble growth and a steady stream of attendant crises. Robertson (1998: 54) articulated these concerns thus: "People are increasingly experiencing the workings of the money, banking and financial system as unreal, incomprehensible, unaccountable, irresponsible, exploitative and out of control."

In this approach, efforts are directed to transforming the financial and banking system, and ultimately the whole economy, so that they will conform to the Islamic spirit, principles and objectives. The concern is not merely to secure the narrow legal compliance of banking and finance practices but a more substantive movement toward a good financial system enshrining Islamic values and principles. Ahmad (1999: 14-15) characterizes such an agenda as a shift from a purely pecuniary and hedonistic profit-taking economy to a gainful economy that is also characterized by ethical norms and social commitments.

3. Islamic Finance Direction

The approach taken in developing Islamic finance is consistent with its *raison d'être*. The reaction to the first *raison d'être* of Islamic finance has been the *formal approach* in developing the Islamic financial system. IBF is structured by maintaining the present financial practices/operations and restructuring the financial instruments/contracts to be compliant with Islamic law to replace the interest-based instruments of conventional banks.

The Islamic finance practice is largely concerned with technical/operational issues of having products or contracts that satisfy Islamic legal requirements. This is done by exerting intellectual effort on achieving legal compliance of financial products by modifying the existing (non-*halal*) conventional products to meet Islamic legal requirements while maintaining the same objectives as the financial capitalist system. Therefore, we see there are almost no conventional banking and finance products that do not have Islamic counterparts.

The current form of Islamic finance is criticized widely as simply duplicating the structure of existing products in the market with the aim to make them Shari'ah compliant (i.e., legally in line with Islamic law). This is perhaps because of the view that

Islamic finance fundamentally shares the same profile and objective as its mainstream conventional counterpart (of maximizing profit) and only differs in form and structure.[5]

This concern for legal compliance in form and structure is, unfortunately, done at the expense of asking more fundamental questions concerning the purpose of finance, the place of finance in real economic activities and the bigger aims it should seek to fulfill. To make matters worse, there is little awareness among Islamic scholars and practitioners of the shortcomings of the existing mainstream financial system, which has been widely criticized, even by Western scholars. Present Islamic finance is still unable to elegantly release itself from the dominant framework of debt-based finance *ala* capitalism. This strategy for Islamic finance development has led many to view it as part of the mainstream conventional system that focuses on trivial issues in current financial practices instead of going deeper to provide a breakthrough on how a just and fair financial system could operate.

While this may be valid, alternatives are also needed lest we end up inheriting similar tribulations as the conventional system. Therefore, at present it is still valid to ask the question as to whether Islamic finance has any goals besides providing interest-free finance by cleansing the interest elements in conventional products. Haneef (2009: 297) warns that the current trend reduces Islam and its Shari'ah to their legal dimension rather than seeing them within a greater civilisational framework. Many parties seem satisfied with having the 'minimum legal requirement' as the standard to be followed instead of presenting Islam as a potential force for developing a new alternative financial system.

For this reason, questions on the viability and contribution of Islamic finance in helping address the major ailments of the Ummah, if not the world, remain the challenge to be addressed. Islamic finance's second *raison d'être*, i.e., the attempt to develop an alternative financial system based on Islamic principles, values and goals, should once again catch the attention of scholars and practitioners. During the first three decades (1970s–1990s) of the discourse of Islamic finance, scholars and practitioners raised various fundamental issues on finance and Islam from a systemic perspective. Islamic finance was presented as part of an Islamic economic system and was contrasted to capitalism and socialism. It was seen as part of a larger socio-economic and political order that had ideological implications. Islamic finance was seen as an extension of Islamic economics, and hence, having economic impact, with developmental goals such as poverty eradication, job creation, entrepreneurial development and greater sharing and distribution of income and wealth. It was not seen as merely a commercial enterprise as it is in modern banking and finance.[6]

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5 Anwar (2002: 1, 9) observes that although the Islamic banks have successfully replaced the practice of interest with other modes like *bay' al-murabahah*, *bay' bi thamanajil*, and *bay' al-'inah*, doubts regarding their Islamicity still persist. This is because there are no substantial changes in financial objectives. Islamic banks in those contracts are not actually interested in real sale as the contract would require. Therefore, to find ways and means to charge for the time value of money, like interest, they pose as traders by engaging in fictitious purchases, adding a profit component to the purchase price to arrive at a selling price for the purchased item, and then sell the item to the customer for deferred payment, treating the selling price as credit (loan) due.

6 Nienhaus (1988: 71), however, observes that the driving force behind most of the new Islamic banks of today is not development but commerce. Their aim is not to change the behaviour of the rural population but to offer the well-established business community most if not all the banking and financial services of conventional banks, but on an interest-free basis.

The systemic approach to establishing a new system of finance would not only address the legal issues of financial practices, but also address the shortcomings of the mainstream financial system and more importantly would attempt to manifest the Islamic worldview or, more specifically, the Islamic economic vision in the financial sphere in order to achieve Islam's economic objectives.

These efforts, although they might be 'once again' viewed as naively idealistic in the dominant system of capitalism, are actually timely and avidly awaited. The recent 2008 financial and economic crisis opened the eyes of the people of the world to the foundational fragility of the current financial system and the hollowness of its promises of progress. Economic crises, inflation, depression and unemployment are inseparable companions of the promises of wealth, growth and profit in the capitalist financial system. It has also been widely realized that the crisis is not the outcome of some sudden and unexpected shock; rather, the crisis has been building since the Great Depression of 1929 and, as Soros (2008: 312) concludes, "was generated by the financial system itself". Krugman (2009) also admits that the current crisis has been due to the profession's blindness to the very possibility of catastrophic failures in a market economy. Mainstream economists not only failed to foresee the crisis, they are also blamed for helping to create it by allowing robust financial engineering techniques to create sophisticated but fragile instruments (derivatives) for leveraging credit and managing risk in the name of increasing potential profit (Kirman, 2009: 80). To solve these systemic errors and, hence, systemic crisis we need a new philosophy to manage the financial system. The calls for a new financial system that is more stable and shock-absorbing, that promotes development and social justice and is able to overcome the inherent stability of the modern financial system cannot, therefore, be dismissed as idle daydreaming.

4. Foundations of Islamic Finance

In the banking and finance sector, the challenge remains in developing a new perspective on finance at the conceptual level or as a practical system. Choudhury (2007: 31), observing the development of Islamic finance, contends that the foundation and principles of Islamic finance at present give no comprehensive vision of a background intellectual matrix of ways to transform the prevailing interest-based environment into an interest-free system.

The on-going doubts about the 'Islamicity' or 'authenticity' of Islamic finance; its proper direction; and the discrepancy between the ideals and realities of Islamic economics and finance should lead us to contemplate the appropriate foundations and structure of an Islamic financial system as well as why we need to develop Islamic finance in the first place. It should be viewed positively as a challenge to develop and direct the practice and industry into a proper and comprehensive systemic dimension. Islamization of banking and finance in this perspective is not aimed at modifying the present structure of conventional banking and finance in an Islamic perspective, instead, it aims at offering new perspective, foundations and approach in finance and develop financial system based on those perspectives/foundations. Therefore, the points for discussion would range from formal issues related to appropriate products and instruments to serve the goals, to the human capital involved in the Islamic finance industry, to the systemic matters of foundations, paradigm, goals, structure and directions of an Islamic financial system.

Serious work in the foundational area of philosophical studies of Islamic economics, banking and finance that can produce the much needed conceptual foundations and frameworks is necessary. Developing a body of knowledge and Islamising modern economic and financial practices cannot be done properly unless we have a clear and coherent philosophical foundation that emanates from an Islamic worldview. It is only with this sound philosophical base for Islamic economics, banking and finance that the body of knowledge can sustain itself or provide genuine Islamic alternatives to contemporary economic and financial practices and the indigenous solutions requested.

The lack of attention to this fundamental area has resulted in body of Islamic banking and finance literature that, despite its size, seems to lack conceptual or theoretical unity and coherence. We agree with Haneef (2009: 295), who says that Islamisation efforts which fail to address foundational, epistemological and ethical concerns relevant to economics and finance will end up making Islamic economics a branch of Western economics and may not live up to the claims that Islamic finance will be the saviour of humankind against crises like the ones we are facing now.

Islamic finance has yet to arrive at a program of comprehensive development by rethinking the foundation of finance from the Islamic perspective. This would include all the queries regarding financial goals, framework and instruments from the Islamic perspective. Emphasis on the technical and operational aspects has limited the discussion in the legal sphere of Islamic finance to developing products that satisfy the requirements of Islamic law as most narrowly construed. Consequently, the substantive structural change leading to a thorough transformation of money, society, finance and the economy has not yet been possible. Islamic finance today is simply pursuing the conventional goals of efficiency and profitability by modifying the external structure, sometimes at the expense of the Qur'anic worldview. This approach arises from incongruent perspectives in understanding the bigger picture of economics in Islam or the Islamic system of life.

The bigger picture of an Islamic financial system having distinct goals and, therefore, distinct financial instruments to serve those goals has still not been produced. Islamic finance products essentially should be structured in line with the nature of the system and in light of Islam's economic vision and goals. That is only natural. Consider the evolution of mainstream finance: its products have been developed to serve the very purpose of the capitalist economic system. *Instruments are designed to serve ends*. The present practices however do not really reflect this, as financial products in Islamic banking and finance seem to be reverse engineered; i.e., the existing conventional products are modified to meet Islamic legal requirements while maintaining the same objectives as the financial capitalist system.

The modern system has to be evaluated from an Islamic foundation of knowledge and its framework. For that purpose, the conceptual foundations of Islamic banking and finance must be developed from its very own sources of Islamic epistemology in the light of the Islamic worldview. A mere 'grafting' or 'transplanting' of Islamic principles/values into it while continuing to work within the Western scientific conceptual scheme will produce conflicting results which, according to Al-Attas (1979: 44), "are not altogether beneficial nor desirable". Unfortunately, in the absence of solid conceptual foundations, today's Islamic economists are still primarily working with the dominant Western conceptual scheme (neoclassical economics), which has been primarily developed by Western philosophers within the framework of their worldviews with the very purpose of serving the economic system (capitalism) they have created.

Likewise, Islamic finance is expected to capture the moral high ground of banking and financial practices in an increasingly volatile world by offering a financial philosophy based on the triumph of ethics and dealing with customers in a more humanistic approach. The moral mastery is the hallmark of Islamic financial professionalism. Customers in Islamic finance services are different from customers in other financial industries. They require more than just having legal financial transactions.

In March 2009, the Vatican, in its official newspaper *L'Osservatore Romano*,said: "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, 2009). The statement declares the message that it is ethical values in Islamic finance that essentially attract audiences to look into it and participate in its operation. It is also basically a hope that with those values Islamic finance would reshape the industry and initiate a new era of banking and finance in the twenty-first century. The current financial system is viewed by many as unethical; it appears to be a casino that enshrines greed to justify highly speculative practices, rather than an industry that empowers people and stimulates productive activities and development.

Therefore, the concern in Islamic finance should be not only with financial products that have the stamp of Shari'ah-compliance from a narrow legalistic perspective but also, and most importantly, with satisfying the ethical and moral imperatives. Law and morality should not be made contradictory in developing Islamic finance, as the Qur'anic worldview recognizes no distinction between legal imperatives and the moral obligation of Divine imperatives. The structure of Islamic finance should essentially reflect the spirit of Islamic values. The prohibition of *riba*, for example, should be understood as not merely the prohibition of any excess charge on a sum loaned, but also a moral prohibition of exploitation of man by man in financial transactions (Rahman, 1985: 7). Ethical issues in Islamic finance would not be perceived as merely legal or regulatory matters, thus disguising the role of ethics in law and regulation. Therefore, *hiyal* (legal stratagems) in developing Islamic finance instruments to evade the law that prohibits *riba* by slick use of mechanisms/processes, while legally justifiable, is not morally justifiable. The practice will not only dislocate morality and law but also annihilate the very spirit of Islamic values and our objective in developing real Islamic banking and finance.

A breakthrough beyond legal compliance towards moral/ethical fulfilment as well as development/civilizational agenda should be attempted. The people are expecting more than having *halal* financial practices. They are also hoping for financial practices with a more human approach and marked by Islamic values of having transparency, cooperation, mutual trust, just and fairness in financial dealing. The consciousness of the practitioners and customers of Islamic finance who think that the task of creating and enforcing ethical rules and standards is their job rather than the job of legislators and regulators could produce an ethical triumph in Islamic financial practices. It would result in greater efficiency, distributive justice and equity, along with ensuring diffusion of resources in the society by going to grass roots and to the community for development. In addition, it would avoid exploitation, moral degeneration and the social tensions that arise from inequity.

5. Conclusion: Moving Forward

With the above explanation on the approach, direction and foundations of Islamic banking and finance, it is clear that the industry has potentials to offer solutions to the people of the world on the good financial practices provided that it is confident with its own principles and philosophy in approaching financial dealings and provided that it realizes its full potentials as a system.

Moving forward, Islamic economics, banking and finance should be developed through a creative and forward-looking symbiosis of the Islamic ideal and the reality in Muslim countries. The reductionist piecemeal approach that emphasises one dimension, such as legal *per se*, is not favoured. It has to be approached as a complete system. There is also a need to make a long-term commitment to knowledge and scholarship now so that comprehensive development that sees Islam as a system and manifests its visions in practical realities can be achieved.

There is a great hope that Islamic banking and finance will have a breakthrough in philosophy and practice. There is also a high expectation that Islamic scholars and practitioners will take up the challenge of being the alternative to the dominant paradigm and genuinely contribute to achieving the civilisational goal of Islam as we face the challenges of the twenty-first century. Islamic finance must demonstrate its superiority to conventional finance not merely by having compliance in legal requirement; beyond that, it must fulfil its potential for managing a good economy, stimulating growth and development, establishing socio-economic justice and promoting employment and stability.

Scholars and practitioners should keep that spirit alive, for people have become very critical of the development of Islamic economics, banking and finance, and they demand more than replicating and modifying existing practices and labelling them Islamic. The 'Islamic' title carries the expectation of a financial system and practices that are truly based on Islamic principles and serve the noble goals prescribed by Islam (*maqasid al-Shari'ah*).

In this light, Islamic finance's progress will be monitored by how well it realizes the *maqasid* in producing a good economy marked by the spirit of brotherhood (*ukhuwwah*) and cooperation (*ta'awun*), social equality and social justice ('*adalah*), just and fair allocation of resources, elimination of poverty, protection of the environment and helping society in achieving wellbeing (*maslahah*). The reputation of Islamic financial institutions is as dependent on its development agenda and moral standing as it is on its financial acumen. A note by DaudVicary Abdullah and Keon Chee (2010: 2) in the beginning of their book *Islamic finance: Why it makes sense* reminds us: "it is not about finding billion-dollar petroleum projects or becoming the next Islamic finance multi-millionaire. Rather, it is to do with alleviating poverty and wealth gaps around the world." The potential of Islamic finance in helping the people of the world to achieve true wellbeing and shaping the world with lofty values of justice, fairness and cooperation will be meaningless if we do not direct Islamic finance in its proper systemic direction. Incorporating those concerns in developing Islamic finance would help ensure better financial returns while making the sector more sustainable.

Having Shari'ah-compliant products is certainly not the endpoint in our effort to develop an Islamic financial system. Proper instruments are the means in our effort to achieve the objectives (*maqasid*) of the Shari'ah. The paradigm should be shifted from a narrow understanding of the Shari'ah, concerned only with formal legal compliance, to a much broader and deeper understanding of the Shari'ah as encompassing the totality of human life. In that sense, it would be a shift from Shari'ah compliance to *maqasid* realization. Effort should be focused on producing financial instruments that are consistent with and serve the higher objectives. Islamic finance needs to be optimized to ensure both the financial and ethical quality of financial products supplied to the public. The *maqasid* essentially invite our creativity to design contracts that would suit our needs and objectives of life. Islamic banks and financial institutions should observe *maqasid* in their corporate objectives and policies and also use them to verify compliance to true Islamic principles (Kamali, 2011).

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