Purity of Islamic Bank: Literature Review

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Abstract: Islamic banking is one of the fastest-growing industries in the world today. The purpose of this research is to find out the implementation of syariah law in Islamic banking based on previous research. Syariah law is the policy that Islamic banks must follow in their operation and value. It can be an alternative for Muslim population to avoid *riba* or usury in their financial activity. Many scholars have been finding that Islamic banking is not pure using syariah law. They just clone the products, systems, and even working culture from conventional banks. Our literature review found that most Islamic banking is still trapped in the wrong environment and their human resource did not get adequate knowledge about syariah.

Keywords: Syariah law, Islamic banks, conventional banks,

1. Introduction

Dual banking systems are two operational models of banking that run in a country, i.e conventional and Islamic banking. Risk-free interest is based on conventional banking while the Islamic banking system prohibited taking in usury or *riba*-based transaction. In another word, Islamic banking can be alternative to Muslims' demand for a Syariah law in their financial transaction[1], [2]

In Indonesia, the intention to have Islamic banking appeared in the middle 1970s when Lembaga Studi Ilmu-Ilmu Kemasyarakatan (LSIIK) and Yayasan Bhineka Tunggal Ika held an International seminar talking about the diplomatic issues between Indonesia and middle-east countries. Unfortunately, at that time the constitution and regulations were not organized yet about Islamic banking. In 1990 Majelis Ulama Indonesia (MUI) at the 4th National Conference (Munas) in Bogor formed a team to establish Islamic banking in Indonesia.

Bank Muamalat Indonesia (BMI) is the first Islamic banking in Indonesia that stood on 1st November 1991 and officially operated on 1st May 1992. BMI was strengthened by the constitution of Indonesia UU No. 7 1992 about banking industries being allowed to operate with a Profit Loss Sharing system. For the past 5 years, Islamic bank in Indonesia has consistently grown and expanded its network all around the country. From 2017 until 2022 the amount of assets consistently extends almost twice every year. Based on the data from the Financial Services Authority (OJK) on January 2022, Indonesia has 15 Islamic Commercial banks and 20 Islamic Business Units with IDR 661.022 Billion assets in total.

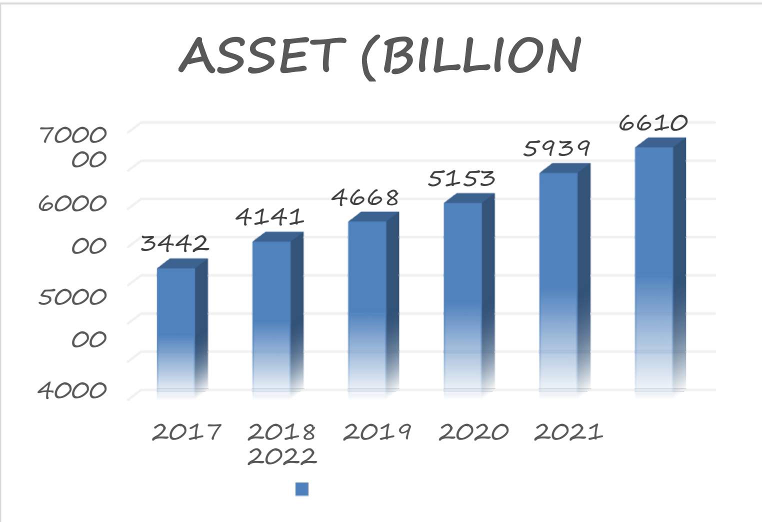

Chart 1. Numbers of Islamic Banking Assets in Indonesia in 5 Years

Source: Financial Service Authority of Indonesia, 2022

Based on The Royal Islamic Strategic Studies Centre (RISC) Indonesia has a 231.06 million Muslim population in 2022 which means it is a huge potential for Islamic Banking industries to grow and expand. Even more, Indonesia got the first rank in Islamic Finance Country Index (IFCI) 2021 and overtook Malaysia which had dominated the index since 2011. Government action is the most crucial factor contributing to the increase in qualitative and quantitative improvement in the industry. As we know, *qanun* (constitutional that line up about the activity financial institution must based on Syariah law) in Aceh province and the merger of the 3 biggest Islamic Bank (Bank Syariah Mandiri, BNI Syariah, BRI Syariah) were the most important steps.

But, the big question and the most thing that has always been argued are how real the Islamic bank applies the Syariah rules. Islamic Banks are not stand-alone institutions. They "live" side by side with conventional banks in an environment do not support the *al-Falah-maqasid* syariah framework. Islamic banks seem to be deeply rooted in the conventional operating system and goals like shareholder wealth maximization [1], [2]

Besides the environment, human resource capability also becomes a gap in the industries. Most Islamic banks have not prioritized the Islamic economy education background as an employee requirement, so they just know about the system through short training from the institution. Sadly, they are not embedded in the concept of divinity with kafah (as a whole) and focus on maximizing the number of targets, so liberalism and capitalism still influence the management of Islamic banks[3].

IBFIs have based their strategies on financial goals rather than ethical and social goals which oblige them to serve society rather than contribute to financing For example, in Malaysia, the use of organized Tawarq, a short-term solution in Islamic circles, increased by 104% between 2014 and 2016 (Bank Nagara Malaysia 2016)[4]. The organized nature of the Tawarru creates debt and facilitates further financialization, which has been strongly criticized by the International Islamic Fiqh Academy as illegal or inconsistent with syariah but is freely used by Islamic banks, as shown by statistics in the case of Malaysia. Situations occur in local Islamic banking operations because the financial institutions themselves do not consider the need to put Shariah objectives at the heart of their operations. On the one hand, they perceive profit as something to be forced. This is also consistent that Islamic banks in Malaysia still appear to be biased in their implementation.

IBF institutions are sometimes guilty of not complying with Sharia, as pointed out by Egypt's Faisal Islamic Bank and Pakistan's Al Baraka Islamic Bank. Additionally, commodity placements typically rely on simple word from borrowing banks/ that funds will not be used for "sinful" activities, and sharia checks are rarely performed to ensure this. This is the IBF equivalent of don't ask, don't say. Therefore, it cannot be said unconditionally that "sin" does not have funds. committing similar frauds, he has no way of knowing how many other IBF institutions there are. their report. It is therefore clear that Islamic banking and finance are almost indistinguishable from traditional banking and finance. What makes it Islamic is finding a suitable Arabic name for an Islamic analog product and using it to justify and give credibility to an Islamic brand name. However Islamic banks structure the transaction, and as long as it is translated into a 'contract' document, it seems to be labeled as Islamic [5].

However, in Pakistan most of the population is Muslim. An empirical study investigating customer attitudes toward Islamic banking, concluded that religious motives have a significant impact on customer behavior in Pakistan[6]. Bank profits and service charges are the main factors in choosing Islamic banking customers, followed by religious goals and quality of banking services. The main reason for this is that the Islamic banking credit system is based on profit and loss sharing whereas non-traditional banks are entirely based on interest rates and instead of opting for Mudarba or Musharika they have fixed interest rates to request. Islamic countries have also made efforts to revolutionize their financial systems by fully adopting Islamic principles[7]. Iran and Sudan are fundamentally restructuring their economies to operate under Islamic financial systems. Pakistan, Malaysia, Indonesia, and the United Arab Emirates (UAE), on the other hand, have strong Islamic banking markets with extensive traditional banking networks[8]

There is no segregation in economic, political, or social in Islam. All these parts are connected as a whole philosophical system [9]. Even though Indonesia has the most population of Muslims in the world, the country itself does not take up the Islamic system in the government structure. Still, the nation organizes religion in its constitution. Ideally, an Islamic bank has to have an environment that supports Syariah law so it does not just pursue profit as the conventional bank does, but also follow Falah [2]

The main purpose of this paper is to describe the gap between the fact and Syariah law in Islamic banking. This article provides an overview of the Islamic banking industry in various countries such as Malaysia, United Arab Emirates, Pakistan and Indonesia

2. Islamic Banking Concept

In Islam, every aspect of life has been set by Syariah law, from worship activities (salat, zakat, fasting, etc), to politics, economics, and business. Mosques and states are not divided[10]. The Syariah system is focusing on justice and well-being in society and the blessing from Allah SWT with an ensuing goal is success in this world and hereafter and an important thing to liberate Muslim society from western capitalism. Five particular features distinguish Islamic banks and conventional banks: (a) underlying philosophy and values; (b) provision of interest-free products and services; (c) restriction to Islamically acceptable deals; (d) focus on developmental and social goals; (e) subjection to additional reviews by the Syariah Supervisory Board [11] [12].

The main principle of Islamic banks is they are not allowed to give and take *riba*. '*Ulama* describes *riba* as additional based on the main capital or funding. Some scholars view *riba* as usury or excessively high rate of interest on loans. The background of these rules came from medieval Arabic culture that compounds the debt if it's not been repaid when due. [10]. Islam has a clear viewpoint about wealth and economic activity. First, the owner of everything in this world including substances is Allah SWT. Human ownership is relative as long as to do the responsibility to manage based on Allah's provision. Second, wealth has a position as a trust, as a test of our belief (iman), and as worship (zakat, infaq, sadaqah). Third, the acquisition of wealth must follow the halal way. Fourth, Muslims forbid centralizing assets just among wealthy people. Fifth, prohibited to do *riba, gharar* (gambling), robbing, and cheating when on the scale

The unique model that distinguishes Islamic banks and conventional banks is the profit-and-loss sharing method (PLS). In the PLS system, the fixed rate of interest replaces with a rate of return that is uncertain and determined ex-post on a profit-sharing basis. Only the profit-sharing ratio between the capital provider and the entrepreneur is making an ex-ante [10][13]. It means that both sides share the profit and loss. This method is in line with the brotherhood principle Syariah transaction. Cooperation and helping each other spirit are the goal of general maslahah (usefulness) lies in the arrangement of social interaction and harmonization of all stakeholder's interests[14]. Based on the PLS system, Islamic banking implements two types of contract:

- *Musyarakah* contracts are close to joint venture agreements or project financing and management participation. Any profit and loss from the project are shared in a pre-determined agreement. Because these contracts are independent legal entities, the bank can finish the joint venture gradually after a certain period or upon fulfilling a certain condition.
- *Mudharabah* contracts a profit-sharing agreement, in which the bank gives the entire capital needed to finance a project, and the customer provides the expertise, management, and labor. The profit from the project is shared by both parties on a pre-agreed (fixed ratio) basis, but if losses the total loss is borne by the bank

Besides two earlier models, other contracts were allowed but were not strictly PLS in nature.

- *Murabahah* financing is based on buying and selling objects with markup pricing, in which the bank is authorized to buy goods for a customer with a price that includes the original cost plus a negotiated profit margin. This contract is the most common method applied in Islamic banking in Indonesia
- *Ijarah* financing is alike leasing. Lessor (bank) retains the risk of asset ownership

3. Islamic Banking in Practice

There are a lot of arguments about how Islamic banking applies Syariah law. Even Indonesia and Malaysia whose country has many Muslim populations still adopt a dual banking system. The environment who do not fully support the syariah law makes Islamic banking look like the "cloning" of the conventional bank. They just substitute the name from interest to profit sharing, and loan agreement to *Akad*. Here, it is listed some issues related to the purity of Islamic banks.

Table 1. Literature relevant to the purity of Islamic banking

Author	Title	Result
Abdul-Baki, Uthman, 2017	Exploring the "Social Failures" of Islamic Banks: A historical Dialectics Analysis	To legitimize and survive Islamic banks have to describe their practice in a way that conforms to the norm of the environment they now exist in. unfortunately, Islamic banks exist where the environment does not share their objectives and goals
Arshad at al, 2016	Issues in Transformation from Conventional Banking to Islamic Banking	The public feels that there is no difference between conventional and Islamic banking due to the huge resemblance in their products
Asutay, 2012	Conceptualising and Locating the Social Failure of Islamic Finance: Aspiration of Islamic Moral	• Interest is still used as an indicator to measure the time cost of money in IBFI in their project evaluation, markup value, and beyond

	Economy vs the Realities of Islamic Finance	• IBFI products still duplicate the conventional • Debt financing has become the majority financing method in IBFI even though asset-based financing should be • None of the IBFIs have developed an understanding of the Islamic Corporate Governance model
Budhijana, 2021	Factors Affecting Sharia Banking Market Share in Indonesia 2018	The business aspect of Islamic banks is very far from the ethical and moral aspects. Promotional communications still use conventional cultures, such as displaying luxury and capitalism. Shidiq (genuine and honest), Amanha (trust, credible), Fathanah (intelligent), and Tabligh (communicative) are the criteria that Islamic banking use as its foundation for communication
Bakhcouche, at al, 2022	Does Islamicity matter for the stability of Islamic banks in dual banking system?	A higher level of islamicity in the environment does not particularly promote Islamic banks' stability in the dual banking system. Furthermore, Islamic banks face intense competition from conventional banks to the point that they follow their practices. Islamic bank has been far away from their goal and practices embedded in the syariah.
Chong, Liu, 2008	Islamic banking: Interest-free or interest-based?	Islamic banking is not very different from conventional banking from the perspective of the profit loss sharing paradigm.
Khan, 2010	How 'Islamic" is Islamic Banking	In most situations, it is not possible for Muslims to avoid riba. Based on El Hawary's fourfold taxonomy, Islamic Banking and Finance (IBF) conditions are: • IBF can not say to risk sharing taking. They still use market interest rates as pricing benchmarks • IBF often has no meaningful underlying material transactions. In the Murabaha transaction generally, the bank does not have the physical assets • The higher fees associated with Islamic mortgages and investment fund is no more just than copying conventional banking/finance • There is no clear statement proving that the fund will not be used for "sinful" activities and rarely syariah audit performed to ensure this

4. Conclusion

From the finding of our review, it can be concluded that the operation of Islamic banks has been far from syariah law. This is caused by the environment (government policy, social, and culture), the knowledge of human resources and the influence of the capitalism economic are still overshadowed and do not support the goal of the syariah principle. Regulators and supervisors should review all condition of Islamic banks, especially if the country use the dual banking system like in Indonesia dan Malaysia. The policy and supervision must be separated from the conventional bank to avoid the similar product and the system.

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