



A STUDY OF THE KNOWLEDGE AND
ACCEPTANCE LEVEL OF ISLAMIC BANKING
AMONG MUSLIM CONSUMERS IN SINGAPORE

BY

NURUL HUDA BINTE ABDUL WAHID

A research paper submitted in fulfillment of the
requirements for the degree of Master of Science in
Islamic Banking and Finance

Institute of Islamic Banking and Finance
International Islamic University
Malaysia

JUNE 2013

ABSTRACT

Islamic banking and finance has emerged since 1970s as an alternative to conventional banking based on *riba*. To date, it continues to capture the interests of both Muslim community and non-Muslim investors worldwide. Its success is partly attributed to its unique branding such as interest-free and ethical banking. Singapore, predominantly a non-Muslim and secular country, aspires to introduce and integrate Islamic finance in its financial sector. Given Singapore's strength in asset management along with its excellent regulatory, operating environment and institutional capabilities, the world's fourth top financial center is poised to develop Islamic banking and finance. One of Monetary Authority of Singapore's early amendments in banking regulation was to remove additional stamp duties on Islamic financial transactions such as *Sukuk* and *Murabaha*, to ensure a level playing field between Islamic and conventional banks. Past studies conducted in Singapore have found poor public understanding of Islamic banking. Therefore, the objective of this study is to ascertain Muslim consumers' knowledge in particular; as well as their acceptance in embracing Islamic banking. 300 survey forms in a questionnaire format was distributed to Muslims serving at various Muslim organizations in Singapore. The findings observe, firstly, moderate understanding of Islamic banking concepts among consumers. Secondly, their positive willingness to accept Islamic banking comes with some underlying concerns and preference. Thirdly, Muslim consumers attitude do not vary much to the masses where preference for service-oriented features in retail banking is concerned. In conclusion, the results of this survey could help banks in Singapore understand the needs and preferences of their target segment, and customize their strategies accordingly to capture the market.

البحث ملخص

لقد برزت المصرفية الإسلامية والتمويل الإسلامي منذ 1970 باعتبارها بديلا عن المصرفية التقليدية القائمة على الربا. ولا زالت حتى الآن تجذب اهتمام المجتمع المسلم والمستثمرين غير المسلمين في جميع أنحاء العالم. ويعزى نجاحها جزئيا إلى العلامات التجارية الفريدة من نوعها مثل الخدمات المصرفية الخالية من الربا والأخلاقية. تطمح دولة سنغافورة ذات الأغلبية الغير المسلمة والعلمانية لتتقدم ودمج التمويل الإسلامي في قطاعها المالي. تستعد سنغافورة المركز المالي الرابع عالميا لتطوير الصيرفة والمالية الإسلامية نظرا لقوتها في مجال إدارة الأصول جنبا إلى جنب مع التنظيم الممتاز والبيئة الإدارية والقدرات المؤسسية. أحد التعديلات المبكرة لهيئة النقد في سنغافورة لتنظيم العمل المصرفي كان إزالة رسوم الختم الإضافية على المعاملات المالية الإسلامية مثل الصكوك والمرابحة لضمان فرص متكافئة بين البنوك الإسلامية والتقليدية. وقد وجدت الدراسات السابقة التي أجريت في سنغافورة ضعف فهم العامة للعمل المصرفي الإسلامي. ولذلك فإن الهدف من هذه الدراسة هو التأكد من معرفة المستهلكين المسلمين على وجه الخصوص للعمل المصرفي الإسلامي وكذلك قبولهم واحتضانهم له. ولهذا الغرض تم توزيع 300 استمارة في شكل استبيان على المسلمين الذين يعملون في مختلف المنظمات الإسلامية في سنغافورة. أظهرت النتائج، أولا، وجود فهم متوسط لمفاهيم الصيرفة الإسلامية في أوساط المستهلكين. ثانيا، استعداد إيجابي لقبول المصرفية الإسلامية مع بعض المخاوف الكامنة والأفضليات. ثالثا، عدم اختلاف موقف المستهلكين المسلمين كثيرا عن الجماهير حيث يعطى الاهتمام لتفضيل ميزات خدمة المنحى في الخدمات المصرفية للأفراد. أخيرا يمكن لنتائج هذه الدراسة مساعدة البنوك في سنغافورة على فهم احتياجات وتفضيلات العينة المستهدفة، وتخصيص استراتيجياتها وفقا لذلك للاستيلاء على السوق.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Islamic Banking and Finance.

.....
Abdul Rahim Abdul Rahman
Supervisor

This research paper was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science in Islamic Banking and Finance.

.....
Ahamed Kamel Mydin Meera
Dean, IIUM Institute of Islamic Banking
and Finance

DECLARATION PAGE

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Nurul Huda Binte Abdul Wahid

Signature

Date

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

**DECLARATION OF COPYRIGHT AND
AFFIRMATION OF FAIR USE OF UNPUBLISHED
RESEARCH**

Copyright©2013 by International Islamic University Malaysia. All rights reserved.

**A STUDY OF THE KNOWLEDGE AND ACCEPTANCE
LEVEL OF ISLAMIC BANKING AMONG MUSLIM
CONSUMERS IN SINGAPORE**

I hereby affirm that The International Islamic University Malaysia (IIUM) holds all rights in the copyright of this work and any reproduction or use in any form or by means whatsoever is prohibited without the written consent of IIUM. No part of this unpublished research may be reproduced, stored in a retrieval system, or transmitted, in any form or by means, electronic, mechanical, photocopying, recording or otherwise without prior written permission of the copyright holder.

Affirmed by Nurul Huda Binte Abdul Wahid

.....
Signature

.....
Date

ACKNOWLEDGEMENTS

In the name of Allah, the Most Gracious and Merciful, All Knowing, All Wise, Peace be upon Prophet Muhammad (S.A.W).

First, I would like to express my utmost gratitude to Allah S.W.T. for granting me the faith and strength to accomplish this task. Without His help, I would not be able to see myself through the challenging moments.

My sincere appreciation to my supervisor, Prof. Dr. Abdul Rahim Abdul Rahman for his commitment, invaluable guidance and exceptional patience with students like myself. I would also not forget the staff of IIUM Institute of Islamic Banking and Finance, whose assistance in the administration matter is much appreciated.

I am greatly indebted to my husband, Muhamed Fauzi bin Abbas, for his undying support and confidence in me, without which travelling to Kuala Lumpur to seek knowledge would not have been possible. Your motto of ‘Anything is possible’ has kept me going.

Last but not least, my special thanks to my parents and parents-in-laws; Abdul Wahid bin Mohamad, Rustina Jalil, Rabiah Abdullah and Abbas bin Mohd Shariff for their continuous encouragement and support in allowing me to pursue my dream overseas. Without their continuous prayers and blessings, I would not have been able to survive this experience. Special mention to all my family members and friends who have always cheered me on in this great journey.

May Allah bless our efforts and guide us in this life and the hereafter. Ameen.

TABLE OF CONTENTS

| | |
|---|----------|
| Abstract | ii |
| Abstract in Arabic | iii |
| Approval Page | iv |
| Declaration Page | v |
| Copyright Page | vi |
| Acknowledgements | vii |
| List of Tables | x |
| List of Abbreviations | xi |
| CHAPTER 1: INTRODUCTION..... | 1 |
| 1.1 Background of Study..... | 1 |
| 1.2 Problem Statement | 3 |
| 1.3 Research Objectives | 4 |
| 1.4 Research Questions | 5 |
| 1.5 Motivation and Significance of Study..... | 6 |
| 1.6 Organisation of the study | 6 |
| CHAPTER 2: LITERATURE REVIEW..... | 8 |
| 2.1 An Overview of Islamic Banking | 8 |
| 2.2 Prohibitions in Islamic Banking and its Rationale | 9 |
| 2.2.1 Riba | 10 |
| 2.2.2 Gharar | 12 |
| 2.2.3 Maysir..... | 14 |
| 2.2.4 Prohibition of selling haram goods | 14 |
| 2.3 Islamic Banking Products..... | 15 |
| 2.3.1 Mudharabah..... | 15 |
| 2.3.2 Musharakah | 16 |
| 2.3.3 Murabaha..... | 17 |
| 2.3.4 Ijarah..... | 18 |
| 2.3.5 Al-Wadiah | 18 |
| 2.4 Historical Background of Islamic Banking..... | 19 |
| 2.5 Islamic Banking in the Republic of Singapore | 24 |
| 2.5.1 Regulatory and Tax Treatment | 25 |
| 2.5.2 Introduction of Islamic Financial Products..... | 25 |
| 2.5.3 Islamic Bank of Asia..... | 26 |
| 2.5.4 Sukuk | 27 |
| 2.5.5 Islamic Real Estate Investment Trust | 27 |
| 2.5.6 IFSB Membership..... | 28 |
| 2.5.7 Public Education | 28 |
| 2.6 Knowledge of Islamic Banking..... | 29 |
| 2.7 Attitudes toward Islamic Banking and Bank | 31 |

| | |
|---|----------------|
| CHAPTER 3: RESEARCH METHODOLOGY | 36 |
| 3.1 Population and Sample..... | 36 |
| 3.2 Research Design..... | 37 |
| 3.3 Research Instruments | 38 |
| 3.3.1 Construction of Questionnaire..... | 38 |
| 3.3.2 Feedback from Pilot Study | 39 |
| 3.3.3 Categories of Islamic Banking Concepts..... | 40 |
| 3.4 Hypotheses Development..... | 43 |
| 3.4.1 Knowledge Level on Islamic Banking..... | 44 |
| 3.4.2 Acceptance Level of Islamic Banking..... | 44 |
| 3.4.3 Religion is not a Significant Determinant in Bank Selection Criteria..... | 45 |
| 3.4.4 Knowledge is not a Significant Determinant in the acceptance of Islamic Bank..... | 46 |
| 3.5 Technique of Analysis..... | 47 |
| 3.5.1 Descriptive Statistics..... | 48 |
| 3.5.2 Pearson Correlation..... | 49 |
| CHAPTER 4: ANALYSIS AND FINDINGS | 50 |
| 4.1 Data Collection..... | 50 |
| 4.1.1 Demographic Background..... | 51 |
| 4.2 Classification of the Level of Knowledge..... | 56 |
| 4.2.1 Level of Knowledge Based on Demographic Background | 67 |
| 4.3 Acceptance Level of Islamic Banking among Muslim Consumers..... | 71 |
| 4.4 Bank Selection Criteria | 83 |
| 4.5 Hypotheses | 85 |
| 4.5.1 Knowledge Level of Islamic Banking | 86 |
| 4.5.2 Acceptance Level of Islamic Banking..... | 87 |
| 4.5.3 Bank Selection Criteria..... | 88 |
| 4.5.4 Knowledge is not a Significant Determinant in the Acceptance of Islamic Bank | 90 |
| CHAPTER 5: CONCLUSION..... | 95 |
| 5.1 Summary of Research Findings | 95 |
| 5.2 Contributions of the Study | 100 |
| 5.3 Limitations of the study | 102 |
| 5.4 Suggestions for Future Research..... | 102 |
| BIBLIOGRAPHY | 104 |
| APPENDIX A | 110 |

LIST OF TABLES

| <u>Table No.</u> | | <u>Page No.</u> |
|------------------|--|-----------------|
| 2.1 | Developments in modern Islamic economic and finance..... | 19 |
| 3.1 | List of sample study..... | 36 |
| 4.1 | Questionnaire response rate | 50 |
| 4.2 | Age group of respondents..... | 52 |
| 4.3 | Respondents' designation..... | 52 |
| 4.4 | Gender of respondents..... | 53 |
| 4.5 | Marital status of respondents..... | 53 |
| 4.6 | Respondents' ethnicity..... | 54 |
| 4.7 | Respondents' monthly income bracket..... | 54 |
| 4.8 | Level of education..... | 55 |
| 4.9 | Level of Islamic education..... | 56 |
| 4.10 | Knowledge level classification..... | 57 |
| 4.11 | General findings on knowledge of Islamic banking..... | 59 |
| 4.12 | Ranking the General Findings on Knowledge of Islamic banking..... | 63 |
| 4.13 | Sample's knowledge level..... | 66 |
| 4.14 | Pearson Correlation based on demographic background..... | 67 |
| 4.15 | Respondents' knowledge level of Islamic banking based on their Islamic Education..... | 69 |
| 4.16 | Likert Scale of respondents' acceptability towards Islamic Banks..... | 72 |
| 4.17 | General Findings of respondents' acceptability towards Islamic Banks..... | 72 |
| 4.18 | Ranking of the General Findings on respondents' acceptance. | 78 |
| 4.19 | Independent T-score test on 2 sub-groups' knowledge and acceptance on Islamic Banking..... | 81 |
| 4.20 | Bank selection criteria..... | 83 |
| 4.21 | Pearson correlation coefficient between knowledge and acceptance on Islamic Banking..... | 90 |
| 4.22 | Results of respondents' knowledge of Islamic knowledge against their acceptance of the bank..... | 92 |
| 4.23 | Summary of hypotheses result..... | 93 |

LIST OF ABBREVIATIONS

| | |
|----------|---|
| AAOIFI | Accounting and Auditing Organization for Islamic Financial Institutions |
| ATM | Automated-teller Machine |
| BNM | Bank Negara Malaysia |
| CIMB | Commerce International Merchant Bankers |
| CIMS | Centre for Islamic Management Studies |
| DOS | Department of Statistics |
| FSA | Financial Services Authority |
| FTSE | Financial Times Stock Exchange |
| GCC | Gulf Cooperation Council |
| GIA | General Investment Account |
| HSBC | Hong Kong and Shanghai Bank Corporation |
| IBF | Islamic Banking and Finance |
| IDB | Islamic Development Bank |
| IFSB | Islamic Financial Services Board |
| IIFM | International Islamic Financial Markets |
| IIRA | Islamic International Rating Agency |
| IMF | International Monetary Fund |
| IRAS | Inland Revenue Authority of Singapore |
| IRTI | Islamic Research and Training Institute |
| ISRA | International Shari'ah Research Academy for Islamic Finance |
| LMC | Liquidity Management Centre |
| MAS | Monetary Authority of Singapore |
| MUIS | Majlis Ugama Islam Singapura |
| MSI | Muslim Savings and Investments |
| OCBC | Oversea-Chinese Banking Corporation |
| PERGAS | Persatuan Ulama dan Guru-Guru Agama Islam Singapura |
| P.B.U.H. | Peace Be Upon Him |
| REIT | Real Estate Investment Trust |
| SGS | Singapore Government Securities |
| SIA | Special Investment Account |
| SPSS | Statistical Products and Service Solutions |
| S.W.T. | Subhanahu Wa Ta'ala (Praise be to Allah and the Most High) |
| VSC | Vector Scorecard |

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND OF STUDY

The emergence of Islamic banks was, theoretically, to counter the practices of Occidental banking system wherein taking and charging of interest (*riba*) is a norm. In 1963, Egypt's Mit Ghamr first experimented on the Islamic banking operating principles by mobilizing funds from savers to users. Subsequently, the government of Egypt gave their support in establishing interest-free institution famously known as Nasser Social Bank.

Such unprecedented motivation to build Islamic banking has created fresh impetus for other Islamic states to follow suit. The number of banks set up in the Middle East region has multiplied over the past four decades. A number of reasons motivated the influx; the oil crisis in the 1970s, the September 11 attack on the United States' twin towers and the growing confidence in the operation of Islamic banks.

The acceptance of Islamic Banking and Finance (IBF) has since drawn the attention of the global community. It has now emerged from a niche market, into a powerful banking sector in the mainstream (Imam and Kpodar, 2010). According to Bankscope (2006), citing from Imam and Kpodar (2010), although it is currently concentrated in the Middle East, North Africa and South-east Asia, IBF is spreading to Sub-Saharan Africa, Central Asia, and Western Europe. The growing success of Islamic Banking is attributed to several factors, namely; the growing acceptance among consumers towards IBF, the ease of exportation of IBF into countries where

conventional banking dominates, such as the United Kingdom, steady market performance and ethical banking features (Eagle, 2010).

IBF has spread across South-east Asia region where large fraction of Muslims in the world resides. Among the leading countries that took great initiatives in incorporating IBF are Indonesia, Malaysia and Brunei. Indonesia, despite its present shortfall in regulatory framework and supervision, lack of efficient institutional structure support and poor public acceptance of IBF (due to their relaxed view towards Islamic principles of finance), the government and regulators are aiming to play a more active role to open up the market, initiate discussions and encourage the launching of new products especially retail and Islamic bonds (*sukuk*) (Venardos, 2012).

Malaysia, however, showed a remarkable experience in the IBF sector. The central bank of Malaysia has given its full support in the establishment of IBF right from 1983 where its first Islamic bank was set up, to making IBF part of the dual banking system. According to Malaysia's central bank annual report 2010, its Islamic banking assets accounted for 21 percent of the total banking assets. This prominent state has, over the years, established a firm infrastructure through efficient financial markets and diverse set of institutions. Malaysia will continue to post strong growth given its commitment in promoting itself as the global hub for Islamic finance.

Singapore's slow and steady participation in IBF remains an irony given its prowess as the world's fourth financial center (Straits Times, 2010). Beginning in 1998, *shariah* compliant banking services were offered by Islamic windows of certain banks. An Islamic window is simply a window within a conventional bank via which banks customers could operate business by taking up *shariah* compatible instruments

only. However, the Islamic window is required to establish a Chinese wall to avoid commingling of funds (Solé, 2007).

Singapore takes on a more light-handed regulatory approach. It is dedicated to providing a level playing field across all sectors of the finance industry, thus recognizing the shared prudential objectives between conventional and Islamic finance (White, 2010). The Monetary Authority of Singapore (MAS) tended to review their banking regulation to suit the needs of Islamic finance.

Singapore has a total population of 5.08 million as at June 2010. Out of the total resident population, 74.1 percent are Chinese, 13.4 percent Malays, 9.2 percent Indians and others 3.3 percent (Department of Statistics, 2010). The Singapore government is aware that it lacks large critical mass of consumers to establish Islamic retail banking sector, hence since its inception, IBF is viewed more as wholesale banking for fund management institutions and for capital markets (Mani and Muto, n.d.). Singapore is certainly leveraging on its strength as an International financial hub equipped with excellent regulatory, tax and operating environment and overall institutional capabilities. It will be a strong platform for growth of Islamic finance (White, 2010).

1.2 PROBLEM STATEMENT

Singapore considers IBF as an integral element in its financial sector. In this respect, it targets on a bigger role in asset management by leveraging on its existing strengths in banking, trade finance, wealth management, insurance and capital market. It does not, however, disregard the functioning of Islamic banking at retail level. Islamic windows offering products for Muslims and non-Muslims alike are essential especially to cater the special needs of the Muslim community.

So far, Singapore has not set any targets with regards to the proportional share of Islamic assets vis-à-vis total assets in Singapore financial center (White, 2010). Nevertheless, Singapore plans to play a catalytic role in the development of Islamic finance in several ways. Firstly, it aims to maintain high standards in the industry and continue collaborating with regulators in facilitating the expansion of Islamic finance. Secondly, to support talent development by way of education. Thirdly, to raise awareness of Islamic finance and support platforms for practitioners improve their knowledge and understanding of Asia and the Middle East (Monetary Authority of Singapore [MAS], 2011). Therefore, what sort of contributions can be made to facilitate the master plan? Responses from the private sector financial industry have been quite pleasing over the past few years due to the increasing Islamic finance projects. From a consumer perspective, this study seeks to contribute by investigating the acceptance level of IBF among Singaporean Muslims. The following objectives shall guide through the course of this study.

1.3 RESEARCH OBJECTIVES

With regards to the problem statement mentioned above, this research aims to explain:

- i. The level of understanding on Islamic banking general concepts among Muslim consumers in Singapore,
- ii. The level of acceptance towards Islamic banking,
- iii. Consumers' bank selection criteria, and
- iv. The relationship between knowledge and acceptance on Islamic banking.

The study aims to focus on consumers' interest in Islamic retail banking, by looking at their knowledge followed by acceptability towards this unique banking industry. Retail banking, in general, refers to banks that provide for mass market

banking services. Its services range from savings and checking accounts, personal loans to debit and credit cards (Muraleedharan, 2009). It is also important for the study to ascertain consumers' bank selection criteria, hence highlighting their preference for selected bank features. Given the information gathered thus far, the study seeks to uncover the pattern between consumers' knowledge and acceptance towards Islamic banking. In other words, would understanding of Islamic banking influence bank patronage among consumers in Singapore?

1.4 RESEARCH QUESTIONS

In the course of achieving the objectives, several research questions are formulated to define the research area. The questions are as follow:

- i. To what extent do Muslim consumers in Singapore understand Islamic banking as an alternative banking system?
- ii. To what extent do Muslim consumers in Singapore accept Islamic banking?
- iii. To what extent do Muslim consumers in Singapore consider religious motives as the main determinant in their bank selection criteria?
- iv. What are the bank selection criteria among Muslim consumers in Singapore?
- v. Is there a positive relationship between knowledge and acceptance of Islamic banking among the consumers?

In addressing the above-mentioned research questions, Muslim consumers residing in Singapore were asked questions within the context of the study. As Islamic banking emerges to meet the needs of Muslims, the questions largely focus on consumers' attitude towards this new banking system. Can religiosity and knowledge of Islamic banking improve the patronage level of Islamic banking in Singapore?

1.5 MOTIVATION AND SIGNIFICANCE OF STUDY

The progress so far made by Singapore in embracing Islamic Finance was rather laggard despite the initiatives taken by the Monetary Authority of Singapore to develop a fair platform for IBF. There are plenty of opportunities available to help realize Singapore's aspirations in the IBF sector (MAS, 2011).

Although the government strategy is to focus on wholesale banking, Islamic retail banking is gradually gaining momentum of their target market through its marketing of innovative financial products such as 'Ar Rihla Regular Savings account' and 'Why Wait *i*-Fixed Deposit account'. In light of this innovation, the study strongly believes that such appeal may attract Islamic banks target market, which is partly the Muslim consumer. Additionally, it is imperative to explore the consumers' attitude in terms of their motivation to embrace Islamic retail banking.

The research questions formulated above will guide the uncovering of consumers' insights pertaining to the sustainability of Islamic banking in the republic. Moving forward, it is hoped that the study would provide an invaluable insight to the relevant players in the industry. It could perhaps help in propelling the current awareness of IBF among Singaporeans to patronize Islamic banks.

1.6 ORGANISATION OF THE STUDY

The study comprise of five chapters.

Chapter 1

Chapter 1 will introduce the background of study, problem statement, research objectives and questions, motivation and significant of study. It briefly presents the organization of the overall study.

Chapter 2

In Chapter 2, the literature review covers five main aspects: overview of Islamic banking, the historical evolution of Islamic banking and its emergence in the republic of Singapore, knowledge of Islamic banking and finally, attitudes towards Islamic banking and bank selection criteria.

Chapter 3

This chapter explains the methodology adopted to address the various research questions of the study. Next, it presents the development of hypotheses of the study.

Chapter 4

Once research design is carried out, its findings will be presented in this chapter followed by some analysis using techniques mentioned in Chapter 3.

Chapter 5

Chapter 5 concludes the entire study by providing the summary findings as well as the limitations experienced during the course of research. Moving forward, suggestions for future research are also shared.

CHAPTER 2

LITERATURE REVIEW

This chapter aims to provide a literature review on the relevant areas of the study. The following sections will begin, first, by providing a brief overview of Islamic banking while distinguishing it from the traditional conventional banking. Secondly it outlines Islamic banking prohibitions and its rationale behind it. The third section describes the common Islamic financial contracts offered in Islamic banks. Next, the study will outline the cases of Islamic banking in Muslim minority countries, for example in the case of Singapore. Finally, it covers the main highlights of the study concerning the knowledge, acceptance level of Islamic banking and bank selection criteria in general.

2.1 AN OVERVIEW OF ISLAMIC BANKING

Islamic banking, as its name suggests, refers to a financial institution that is built upon the divine Islamic principles. It is also commonly known as *shariah* banking or *riba*-free banking. The emergence of Islamic banking is relatively new as compared to the conventional one that exists as far back as 14th century (Ferguson, 2008). Unlike the latter which is profit-oriented, Islamic banking objectives are mainly to offer financial services that are strictly in line with *shariah* principles, facilitate stability in money value, encourage economic development and equitable distribution of resources (Kamal Khir, Lokesh Gupta and Bala Shanmugam, 2008).

Like any other financial institutions, money is the cornerstone of Islamic banking. However, Islamic standpoint on the concept and functions of money differ contrastingly from modern capitalist theory. Usmani (1998) explained that the

differences stem from Capitalist's theory concerning commercial transactions; there is no difference between money and commodity, both could be traded either at par or any amount so long it is on a mutual consent. Islam, on the contrary, considers money as no more than a medium of exchange and has no intrinsic value. Unlike commodity that has different qualities, money cannot be exchanged other than at par value, either on spot or deferred mode.

Bearing in mind Islamic precepts on money, clearly, one could see great difference as to how Islamic finance and conventional finance deal with money. In terms of economic development, conventional banking's role is fundamentally built upon a debtor and creditor relationship (Ferguson, 2008). On the contrary, Islamic banking is expected to participate in profit as well as loss of their clients' business and wealth management. Furthermore, Islam emphasizes strongly on the importance of etiquettes and adherence to the prohibitions in Islamic finance matters. While these may appear prohibitive in nature, they do not restrict nor deter the expansion of ethical banking.

2.2 PROHIBITIONS IN ISLAMIC BANKING AND ITS RATIONALE

There are numerous etiquette guidelines and prohibitions placed upon Islamic financial transactions. Such rulings are derived from the sources of Islamic law, primarily the Holy *Quran* and the tradition (*Hadith*) of the Prophet Muhammad, peace be upon him (*pbuh*). These restrictions are put in place in order to safeguard human rights, property rights as well as environmental rights. The ensuing sub-sections will address the main prohibitions such as *riba*, uncertainty (*gharar*), gambling (*maysir*) and the channeling of funds.

2.2.1 Riba

Riba is derived from the term *rab-aa*, which means to increase or exceed. According to Yahia (2010), the original teachings of Judaism, Christianity and Islam prohibit lending money and charging interest or usury. In fact, the act of charging interest is also forbidden in Buddhism, Hinduism and many other faiths. Muslims are taught that practicing in the culture of interest, that is charging and borrowing interest or witnessing interest-based contracts, is divinely prohibited (*haram*). This is evident in *Surah Al-Rum: 39*, Allah s.w.t decreed “*That which you give as Riba to increase the People’s wealth increases not with God: but that which you give in charity, seeking the Goodwill of God, multiplies manifold*” and in *Surah Al-baqarah: 275*, “*Those who take Riba shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: ‘Trade is just like interest’ while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist, may keep their previous gains, their case being entrusted to God: but those who revert shall be the inhabitants of the fire and abide therein forever.*”

Prophet Muhammad (pbuh) had also emphasized the great danger of *riba*, thus warning mankind the following “*Riba is of seventy different kinds the least grave being equivalent to a man marrying his own mother*”, as narrated by Ibn Majah, Baihaqi and quoted from Hosein (2001). There are generally two types of *riba*: *Riba Al-Qard* which is *riba* in loans and *Riba Al-Buyu’* involved in trade. The former occurs in a transaction where there is an unequal exchange of amount of money. As mentioned in the preceding discussion on the concept of money, the conventional banking system puts a price to money, terming it as cost of funds (commonly known as interest rate). It is this rate that that has been stirring up issues in Islamic banking as

it should do away with *riba*. In sum, the prohibition of *riba* is central to Islamic banking and finance as a whole hence it is imperative that we seek the rationale behind it.

It is foremost important that Muslims should stay away from *riba* as the divine legislation comes from the Lord, as stated in the Holy Quran. Equally important is to see the logic and understand its implications. The first and most plausible implication on the effect of *riba*, from an Islamic perspective, is its injustice nature prevalent in the *riba*-based banking. First, transactions based on interest violate the equity aspect of economic organization. For example, a borrower must make good of his loan contract with a pre-determined interest rate even his business is not making profit. The rate itself, may be too exorbitant thus causing huge burden onto the borrower. It is in such situation that wrongful appropriation of one's property occurs by force. Clearly, the bank does not participate in the business; it is absolved of business risks yet he is entitled to some portion of the profit. Second, the *riba*-based banking system is security oriented instead of growth oriented. It is of huge concern for banks to make sure safe return on the principal lent coupled with the pre-determined interest in return for interest to their depositors. On that grounds banks would be more inclined to lend to 'credible' borrowers with strong collaterals (Mohd Daud, 2008).

Ahamed Kameel (2009) explained that the nature of the fiat-monetary system has a far damaging impact particularly on developing nations as well as the environment. When these countries borrow internationally, it is impossible for the loans to be paid in total at any given time, some countries are bound to default and the interest portion and defaults can only be repaid in real terms. Given that such countries are less advanced in terms of technology, repayment is made by means of

agricultural stock. As a result, it would only depress the environmental condition such as higher deforestation of that country.

Mohd Daud (2008) also argued that *riba* activities contradict with Islamic law where wealth is concerned. Islam highly encourages actual wealth creation, however, with the *riba*-based system it only creates ‘artificial’ wealth creation and eventually executing wealth transfer. *Riba*-based lending activities can be seen as worse than gambling even though winners and losers in a gambling activity are equally exposed to chance and risk. Interest, however is a zero-sum game, where lender gains at the expense of the borrower.

2.2.2 Gharar

Gharar literally refers to uncertainty, risk or hazard, describing a situation of a probable adverse outcome. The prophet tradition has forbidden *Gharar* sale contract (*Bay’ Gharar*). In the context of trade, Muslim jurists unanimously agreed that only excessive *gharar* is prohibited as it invalidates the contract. But the issue remains as to where the line is drawn between major and minor *gharar*. Citing from El-Gamal (2006), a number of classical jurists propound a cost-benefit analysis to illustrate the difference between minor and major *gharar*:

“Bay Al-Gharar is any sale where gharar is a major component, as such it is unanimously forbidden. However, minor Gharar would not render a sales contract defective since no contract can be entirely free of Gharar. Consequently, scholars differ in opinion as to which contracts are defective based on their assessment of the extent of gharar in the contract. Hence the determining factor points to the presence of major component of Gharar in the sale contract rendering it invalid. The corrupting factor of Gharar is that it leads to dispute, hatred and devouring

other's wealth wrongfully. However this corrupting factor would be overruled if it is opposed by a greater benefit."

Reflecting on the degree of permissibility of *gharar* in Islamic transactions, Al-Saati (2003) categorizes them into four types: the prohibited *gharar*, the permissible *gharar*, the acceptable *gharar* and finally, the mandatory uncertainty. The first type, which is prohibited, relates to the action of voluntary and deliberate *gharar* taking. Ibn Taimiyah and Ibn Al- Qayyim treats exorbitant *gharar* as a type of gambling where consequences are concealed, hence ruling *gharar* sale as causing injustice and enmity in society. On the contrary, permissible *gharar* is allowed in the absence of general agreement among the schools of jurisprudence that such contract is considered invalid. Examples of permissible *gharar* contracts include 'two sales in one', 'the option sale' and '*gharar* due to non-existence of the object' where the latter needs to be built in order for it to be in existence. Here, jurists have ruled the building and manufacturing contracts (*Salam and Istisna*) permissible.

Acceptable *gharar* carry the attributes of randomness facing individual where such uncertainty is mutually exclusive and exhaustive states of nature. For example, risks which are inevitable in a business trade and commercial transactions. The mandatory *gharar*, however, is a prerequisite to the validity of contracts such as *Musharakah*, *Ijarah* and *Mudharabah* where the occurrence of uncertainty is prevalent. In fact, it is in the spirit of Islamic legal maxim "Revenue goes with liability" and "Damage and benefit go together" that such uncertainty is cherished and essential for a trade or business to thrive. In other words, the above spectrum of *gharar* distinguishes between the risk connected to normal business transactions and the kind of uncertainty that is used by one part at the expense of another.