Towards a sustainable socio-economic development: Is there a need for a socially inclusive financial system?

1. Introduction.

The enormous scale of the global financial crisis has shocked the gate keepers of the conventional financial system of its stupor. The current challenges caused by an unsteady global financial system provide an opportunity for the Islamic finance industry to highlight the virtues of *Shari'ah*-compliant financial system. Krichene and Mirakhor (2008) argue that Islamic financial system that based on no interest and *zakat* will be immune to instability, and that a system based on interest is inherently unstable and prone to repeated crisis and losses. Hence, Islamic financial institutions have remained quite secured from the global financial downturn because *Shari'ah* law strictly forbids them from trading with interest-based financial products and instruments (Chapra, 2004, 2008a; Damak *et al.*, 2009; Ebrahim, 2008).

Furthermore, *riba* (interest) free and *gharar* (uncertainty) free nature of Islamic banking together with real asset/service-backed transaction, guarantee that strong risk management device is in place in Islamic financial institutions (Damak et al., 2009; Khan, 2009; Usmani, 2009) which make them immune from the financial crisis. This mean that direct investment for such institutions in sub-prime assets and their derivatives, such as collateralized debt obligation (CDOs) and special investment vehicles (SIVs), is prohibited in Islam following the principle of no *riba* and no *gharar*. The unwillingness of Islamic banks to utilize sophisticated financial instruments, conservative lending and investments enabled these banks to maintain positive and to accommodate the severe impact of the current challenging global financial atmosphere (Hassan and Kayed, 2010). Thus, the financial stability demonstrated by Islamic banking and finance is partly reflected by strict compliance with corporate and *Shari'ah* governance and the fiduciary duties in Islamic banking transaction. Nevertheless, while Islamic finance has demonstrated its resilience during this period, the industry is arriving into an environment that is essentially different in this post-crisis period.

In addition, efficiency of financial market and competitiveness of financial system are closely linked to economic growth. International evidence shows that financial crisis or instability can harm economic development and create unemployment and social insecurity (UPDATE, 2009). For instance, according to World Economic Outlook UPDATE (2009), the crisis has led the percentage of global economy growth in 2009, decreased by half percent when measured in term of purchasing power parity. It is also decreasing household wealth and prompted households and businesses to postpone expenditures, therefore reducing demand for consumer and capital goods (UPDATE, 2009).

True development cannot, however, be realized by concentrating only on the economics segment through satisfaction of material needs. It is necessary to develop both the economic and the social aspect in order for a country to be truly evolved (Chapra, 2008b). Among important features of the social needs that are necessary for realizing human well-being are healthy environment, education, medical care, nutritious food, clean water, comfortable housing and others. Therefore, even though the Islamic banking and finance is immune to the financial crisis, it should take another step further by embracing an evolving role to sustain socio-economic development.

The Islamic financial services can play a vital action in alleviating perennial human development problems such as poverty and child mortality. This can be achieved by efficiently channeling financial resources towards productive opportunities such as to create an environment that can provide entrepreneurship opportunities for the poor and the landless in rural and urban areas.

In addition, Hamid (2005: 11) suggests that among other thing expected to sustain the socio-economic development is to create opportunities for generation of employment and increasing earnings of rural and urban poor (men and women). Financial resources should be channeled to alleviate hardship such as to extend investment facilities to the poor and needy for carrying out their activities; finance proposals for creating self-employment, particularly for the unemployed youths; extend investment facilities to such apparently unproductive activities (at least in the short run) as house building / repairing, hand tube wells for pure drinking water, sanitary latrine, children's education, medical care and the like; and bring the potential small entrepreneurs within the fold of an institutional framework based on Islamic principles (Hamid, 2005:12).

Evenly imperative is spiritual and ethical upliftment which serves as a means for the realization of not only justice but also the accomplishment of all other needs (Chapra, 2008b). Some of the other equally vital and generally recognized requirements for sustained well-being are security of life, property and honour, individual freedom, moral as well as material education, proper upbringing of children, family and social solidarity, and minimization of crime, tension and anomie (Chapra, 2008b). It may not be achievable to sustain long-term development of a society without undertaking adequate satisfaction of all these needs. Consequently, failure to satisfy all these need will lead to a despair life and depression. The primary objective of this paper therefore to examine these issues based-on a critical review of pertinent literature on the need of socially inclusive financial system in relevance of Islamic finance and its potential contribution towards socio-economic development.

This paper is organized in five main sections. Following the first section is the second section which reviews the causes of the current global financial crisis. The third section debates the need for a socially inclusive financial system. Section four explores the current state of Islamic finance, the *Maqasid Al-Shari'ah,* and Islamic finance initiatives to further work it projected role in fostering socio-economic development through *zakat* and *awqaf.* While section five will concludes the paper.

2. The Global Financial Crisis

The current financial crisis has its starting point in the innovation of securitizing sub-prime mortgage loans. It started as a crisis in low-quality mortgage loans in US and then it burst into a full-blown financial crisis. Later, it twirled to be uncontrollable because the institutions that were making those mortgage loans were dependent on other organizations for the money that they used. Therefore, very quickly, this twisted into a catastrophe impinge on financial institutions everywhere and triggered economic downturns around the world (Zaman, 2008). It was deemed as the most terrible in the post war period in scale and international dimension (Krichene and Mirakhor, 2008). Thus, it is argued that the current crisis may lead to global imbalances that indicate a danger to global economic and financial stability.

Chapra (2008) states that the primary cause is the inadequate market discipline in the conventional financial system. There is no risk-sharing in that system. For example, all deposits are guaranteed. Therefore depositors become complacent and do not monitor the banks carefully and do not demand transparency. On the other hand, banks rely on the crutches of collateral, which ensures the repayment of their loans. They do not evaluate the risks carefully and tend to extend credit excessively (Chapra, 2004).

Ebrahim (2008:113) argues that there are several reasons that cause the financial crisis such as:

> "(i) the fragility of the financial system stems from the very nature of *ribawi* (interest-based) contracts; (ii) the regulatory environment prior to the crisis was quite lax; (iii) moral hazard on the part of mortgage originators also played a part in the crisis; (iv) fraud too played a minor part in the system; (v) credit guarantees in the form of credit default swap (CDSs) proved worthless, as the guarantors themselves did not have adequate capital reserve in assets."

However, having said that the Islamic finance industry is more resilience to the financial crisis; it is not risk immune though. They might be immune to certain interest rate risks but not to business cycle and economic risks. They are immune to the sub-prime crisis as *Shari'ah* principles do not allowed Islamic banks to trade debt. In addition, they are also immune to the credit crunch because they are not allowed to invest in derivatives products that are interest-based. Despite all that, an Islamic bank faces a variety of risks in addition to the risk faced by a conventional bank such as reputation risk, *Shari'ah* non-compliance risk, product/mode of financing risk, process risk, counter party risk, etc (Usmani, 2009).

The crisis proved that even sophisticated financial systems are very vulnerable and exposed to many risks. The source of all such crises lies in the interest-based financial system (Chapra, 2008a:119; Ebrahim, 2008:113). The instability of the interest-based financial system is due to lack of coordination between savings and investment (Ebrahim, 2008:114; Mirakhor, 2008:133). As Mirakhor (2008: 133) further explains, there was no assurance that an amount of money lent in the spot market for extra money assured in the future was indeed moving towards employment-generating investment projects in the real segment of the economy. Thus, the crisis has made the search for financial stability an imperative and essential issue globally.

3. The Need for a Socially Inclusive Financial System

The global financial crisis was preceded by a food crisis that disrupted the international agriculture economy. It has been expected that another 100 million people around the globe had been driven into poverty as a result of the increase of food and oil prices. Hundreds of millions in poverty-stricken nations try to balance their household funds on incomes of US$2 a day or less (Ihsanoglu, 2009). Even though Muslim world economies are developing their embedded capital, there remains an immediate need for infrastructure investments across key sectors such as power, water, healthcare and education (Khan, 2010).

Hence, there is a need for a new form of financial system that gives a high importance attributed to social development and human well-being within the Islamic worldview. One of the objectives of Islamic economics is to be socially responsible. Thus, the new financial system is to provide social and community finance to those in need especially to vulnerable group and reinforces social unity without leaving the importance of Islam in it. This type of financial system should be people-centered and concentrate on local capacity building by empowering the needy, encouraging local sustainable venture and overcoming financial and social exclusion (Sairally, 2007).

A socially responsible role has been assigned to Islamic banks by some contributors to the Islamic economics literature where the institutions are called upon to play the role of universal banks in promoting socio-economic development. As the name suggests, Islamic banking is first and foremost about religious identity and duty (Dusuki, 2008). The values of Islamic banking as prevailed within the sphere of *Shari'ah* are expressed not only in the details of their transactions, but in the extensiveness of their role in society as a materialization of religious belief and a dedication to addressing the issue of income inequality, poverty eradication and social justice (Dusuki, 2008:55).

Dusuki (2008) further argues that with such a remarkable growth of Islamic banking over the last three decades, it is time for the industry to be reoriented to stress on matter relating to social and economic ends of financial transactions, rather than overemphasizing on making profits only. Islamic banking and finance itself is perceived by a number of Muslims as a social enterprise whereby Islamic banks are expected to play a socially responsible role in the development process. Islamic banking is believed to have the great potential to be involved in microfinance programmes to cater the needs of the poor who usually fall outside the formal banking sector (Dusuki, 2008:55).

The socio-economic development role of Islamic banking and finance was in fact reflected in its early experimentations in the 1960s. In 1962, for instance, Tabung Haji Malaysia started its operations to help Muslims in Malaysia save for the performance of hajj while at the same time opening opportunities for their active participation in high profile investment activities such as industry, services, plantation, property and real estate. This early experiment reflected the ethical and indigenous form of Islamic banking and finance, especially the form of community banking that it proposed and its advantage of strengthening local economies and serving local communities.

The Islamic resurgence which swept many parts of the Muslim countries was the starting point of the modern Islamic banking system. The main idea of these revivals was the application of Islamic teachings in all aspects of life (Haron and Shanmugam, 1997:25).Since Islam prohibits interest, it is obvious that the elimination of interest from the economic and banking system became top priority among Muslim scholars. The establishment of Mit Ghamr Local Savings Bank in 1963 in a provincial rural centre in the Nile Delta of Egypt marked a milestone in the revolution of the modern Islamic banking system. Further developments also took place in Egypt with the establishment of the Nasser Social Bank (1971), a social lending institution assisting the poor and needy citizens and financing students and small-scale entrepreneurs. Another major highlight was the launch of the Islamic Development Bank (1973) which helps member OIC countries in development project funding.

Islamic banks are considered as the end product of the Islamic resurgence which started within Islamic communities especially during the end of 1960s and early 1970s. One of the most important issues which was widely discussed during this period was the transformation of the economy from a capitalist to an Islamic order. As a result, Islamic banks should be different from the conventional banks because they would be concerned only with real economy and would encourage saving and discourage speculation. If this is done correctly, Islamic banking will fundamentally differentiate itself from the current capitalistic system (Alchaar *et al.*, 2008).

Currently, Islamic banking industry represents a small but growing division of the global banking industry. In some countries, such as Iran and Pakistan, Islamic banks are the only mainstream financial institutions while in other countries, Islamic banking exists on a parallel basis with the conventional banking (Haron and Shanmugam, 1997; Ilias, 2009:1). However, encouragement for Islamic banking and finance varies in the Middle East. In some countries, such as Libya and Morocco, Islamic banks are considered by some to be tied to Islamic political parties and consequently have been refused licenses (Ilias, 2009:2). Other countries, including Jordan, Tunisia and the Sudan, have been accessible to Islamic banking, considering Islamic financial products as an opportunity for creating capital and nurturing economic development (Ilias, 2009:2).

Ilias (2009) further highlights that the Persian Gulf and Southeast Asia historically have been and continue to be the main centers for Islamic banking industry. The market for Islamic banking and finance is currently most developed in Malaysia, Iran and the majority countries that form the Gulf Co-operation Council (GCC) (McKenzie, 2008).However, as noted by Mckenzie (2008), the industry is moving beyond its historic boundaries in these countries into new territories both within and outside the Arab world. Other Arab countries that have Islamic banking are such as Egypt, Turkey, Lebanon and Syria. While for other Asian countries, examples are such as Indonesia, which has the largest indigenous Muslim population in the world, and China.

The Islamic financial system has also landed in Western countries such as the US, France, Germany and the UK, where each of the country has indigenous Muslim populations of between one and five million (McKenzie, 2008). For instance, in August 2004, the United Kingdom's Financial Services Authority (FSA) approved a banking license for the Islamic Bank of Britain (IBB), the country's first Islamic bank (Ilias, 2009:2). This is a proof that Islamic banking is also growing in the Europe, areas which Muslims are considered as minority. As further stated by Ilias (2009:4) one of the reasons why Western countries are interested in Islamic banking is because the industry presents significant new business opportunities and provides alternate methods for capital formation and economic development. Hence, Islamic banks today, not only existed in almost all Muslim countries but have also operated in the other part of the world to serve Muslim and non-Muslim customers (Haron and Shanmugam, 1997:1; Ilias, 2009).

Since the elimination of interest has generally been the first step in the Islamisation of the economy, it is perhaps only natural that the formation and the operation of Islamic banks be given more attention (Haron and Shanmugam, 1997:29). In addition, some challenges to economic development still remain, which are being slowly addressed. Financial reforms are required to bring efficiencies to capital allocation. These financial reforms can be achieved by promoting private sector to channel the savings into productive and efficient investment. Furthermore, it should introduce domestic banking competition and reduce public sector involvement.

Like any other business organization, Islamic banks are expected to make a profit from their operations. It is considered unjust for Islamic banks if they are unable to provide sufficient returns to the depositors who entrusted their money to Islamic banks. Even though making profit from business is acceptable; however, the accumulation of profit without utilization for the betterment of the society is prohibited. This moral and social obligation is stated in the Verse 19 of Chapter 51 of the *Qur'an*:

> *"And in their wealth and possessions (was remembered) the right of the needy, Him who asked, and him who (for some reasons) was prevented."*

Because of this revelation, Islamic banks are expected to be more sensitive to the needs of society, promote more welfare programs and activities, and make more contributions towards the needy and the poor (Haron and Shanmugam, 1997:35). On the other hand, the goal of conventional financial system is profit maximization, which most of the formal intermediaries like commercial banks consider low-income households as "too poor" to rescue, thus further emphasizes the risk of supplying credits to them (Dusuki, 2008:51).

Nevertheless, as an Islamic business institution, all the Islamic banks not only have to run their business to achieve their goal of making profit, but in the same time the banks are expected to adhere to the rules and laws of *Shari'ah*. The *Shari'ah* serves as the foundation for Islamic banks that require them to uphold justice, equity and fairness in managing their business affairs. In addition, it is also necessary for Islamic banks to focus on not only the double objectives which is to earn profit and preserve Islamic ethics such as free from *riba*, honesty, fair and just trade but inclusive also on the social mission, which is to more effectively empower Muslim communities and enhance socio-economic development (Sairally, 2007:20). For instance, Islamic banks need to preserve the commercial objective such as offering viable and competitive products, enhancing product and service quality, maximizing profits and minimizing cost of operations (Amin et al., 2009:216).In this way, it will develop the economic of the society in the same time.

As a platform for building the Muslim world, Islamic financial services is also expected to provide improved social, financial and environmental development and assist in diminishing destitution in underdeveloped areas. Consequently, it requires balancing the protection and upliftment of the needy whilst maintaining incentives for private sector entrepreneurship. Hence, it will help in improving individual live and enable more individuals to be involved in the vigorous of economic development.

From the religious point of view, the establishment of Islamic banks is considered a righteous move for two reasons. Firstly, its existence is in line with the divine revelation, which is to involve in trade. The best example was the Prophet Muhammad (pbuh). In his early life, he used to be a trader. Secondly, Islamic banks provide an avenue for Muslims to perform banking business in the Islamic way, which is free from the element of *riba* (usury).

In order for Islamic financial institutions to foster stability, it is crucial to develop an efficient and sound financial institutions and markets. In doing so, the public's participation in the economic development is essential to achieve a sustainable development and a just social progress. The financial system can promote such participation by making its services both acceptable and accessible to the public.

In addition, to make the services of financial institutions acceptable and accessible to the public, their trust and confidence has to be captured first. There are a lot of factors that can increase the confidence of the public in the financial system. Among the factors that could contribute to enhance the trust and confidence of the public are efficiency and transparency of the institutions, governance structure, excellence service quality, regulatory and technological environments.

Islamic banking is more than only a financial contracts or a prohibition on *riba.* According to Shahinpoor (2009), social steadiness and economic development entail honesty and a sense of community. This then led to his argument that banks and financial corporation organization, like any other aspects of an Islamic society, are required to play a role for a just social order by means of economic development and the equitable distribution of income and wealth. He further notes that everyone and every institution in the society are accountable for supporting the poor to become productive members of the economy. Through providing interest-and collateral–free financial funds consistent with Islamic *Shari'ah*, Islamic bank become significant in encouraging the formation of small businesses by the poor people (Shahinpoor, 2009:998).

The services provided by the financial intermediaries should include all level of the public and not only one particular type of customers such as corporate customers or high level income customers. By reaching the poor people in the communities, the banks are opening the door for them to move out from their poverty. This type of microfinance is crucial in order to have a better distribution of wealth. It then will lead to more poor people become medium class income owners, and promote more saving and investment by small and medium entrepreneurs. Consequently, this will build the base of a proper economic development.

Despite of the remarkable infrastructure established by the Islamic financial institutions, the public especially the Muslim societies and communities are more concern with the compliance of the financial services with *Shari'ah* rules and principles. The compliance is the essential features that differentiate the Islamic financial institutions with the conventional financial institutions. Even though the Islamic financial services have to cater to such specific needs of society, it could appeal to other segments of the population so long as the quality of these services is at least comparable with the conventional ones.

Nonetheless, Islamic banking and finance can play vital role in fostering socio-economic development. It should promote more investment mindset rather than the banking mindset (Khan, 2010). This will lead to more asset creation or building asset rather than promoting debt. Khan (2010) further argues that, the industry should pay attention and sensitivity to real economy impact by incorporating asset-backed instruments and promoting real economy venturing. In addition, the Islamic financial institutions should create opportunity through cross-border partnership by being intermediary in bringing private sector cross-market ventures and alliances.

Furthermore, the industry is in need of strategic direction and combined efforts to be able to sustain the socio-economic development. The Islamic financial institutions can promote the socio-economic growth by being a social financial intermediary. In other words, Islamic banks can provide a microfinance services. This can be done in two ways namely; linking approach (existing financial institutions can do it through specialized windows), and specialized institutions approach (NGOs, non-profit organizations, etc.) (Ahmed, 2009).The Islamic bank can utilize the same format as microfinance institutions. In addition, to make it more manageable, the Islamic banks can open up a separate department or unit for financing medium and small entrepreneurs. To be cost efficient, the Islamic banks can use the existing infrastructure (bank offices) for financing the medium and small entrepreneurs operations. Hence, all these strategies will only be successful with the backing of the regulatory reforms, political support, sufficient human capital and enabling framework.

4. The Present State of Islamic Banking and Finance and the *Maqasid Al-Shari'ah*

The average annual growth rate of Islamic financial institutions assets during the 1995-2008 period is estimated to have been 10-15%, according to various sources (Abdullrahim, 2010:31; Dusuki, 2008:50; Khan, 2010; Osman *et al.*, 2009:198). At the moment, more than 400 Islamic banking and finance institutions are operating worldwide, which are claimed to manage assets worth no less than US$950 billion (Asutay, 2010; Khan, 2010).

According to Asutay (2010), Islamic banking and finance aims to achieve the aspirational objectives such as community banking (serving communities, not market) and responsible finance (as it builds systematic checks on financial providers; restrains consumer indebtedness; promote ethical investment and corporate social responsibility initiatives). However, a critical examination on the above objectives, indicates that the realities are far from fulfilling these objectives (Asutay, 2010).

Even though the early practices of Islamic finance and the emphasis in the Islamic economic theory is on economic development, the general perception felt is that Islamic banks are lacking in their involvement in community development (Sairally, 2007:22). As regards to community-banking objective, the Islamic banking and finance claims that they are not charity organization despite the social expectations, and they have to adapt in order to survive in the competitive business world. The explanation provided on this issue relates to the shift in emphasis from social banking to profit-and-loss sharing and profit motive as a result of the modeling of Islamic banking and finance. The emphasis is observed to be on such activities like product development, financial engineering, efficiency building, viability and profitability and, if social role is to be endorsed; it is only made peripheral to the activities of the institutions. This indicates that profit maximization is their ultimate goal, which shows that they have done little to contribute to capacity building in the communities (Asutay, 2010).

It is difficult to change the emphasis of the current Islamic banking, which is from profit motive to social and community banking. However, new initiatives should be done such as to promote more programmes which support the social and community banking. For instance, government and regulators can contribute into this matter by imposing rules and regulations that required the Islamic financial institutions to take part in the community banking and reporting the activities in their annual financial report. As a result, these banks will gain more public trust, which then lead to an opportunity to retain it competitiveness and attractiveness. In addition, as part of the solution, it is necessary to conscientiously unify the current split between ethics and economics. It is only through the synthesis of both economic efficiency and ethics that a different goal (societal responsibility) with the *Shari'ah* requirements will be brought about.

As regard to the responsible finance, it is argued by Asutay (2010) that there is no universally accepted regulatory body that systematically examines Islamic financial providers. Even though there are some initiatives by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain and Islamic Financial Standard Board (IFSB) in Malaysia, they are not generally adopted. Thus, the level of awareness of public on such initiatives should be increased by educating not only the practitioners, accountants and auditors but also introducing it as part of the syllabus of the tertiary education. The academic world could also invest time and effort to contribute to inform students and professionals in particular, as well as the public at large.

There has also been heavy bias of debt financing such as *murabahah* and short-term trade-based financing transactions in the portfolio of Islamic banks relative to the use of profit-and-loss sharing arrangements (*musharakah*) as advocated in the literature (Al-Ajmi *et al.*, 2009:1087; Asutay, 2010; Sairally, 2007:22). Sairally (2007) further argue that:

> "Islamic banks have been claimed to:
>
> (i) Mirror conventional finance by adopting interest-like fixed return instruments.

(ii) Choose financial product so that they are as closest as possible to the efficiency level of conventional financial products while they neglect the equity criteria of concern to Islamic jurist.

(iii) Direct financial resources into consumption channels rather than into production.

(iv) Direct the contribution of Islamic finance towards the growth of money by encouraging customer indebtedness instead of the growth of the economy by linking financial services to the real and productive sector."

The failure of Islamic banks to develop more risk sharing mechanisms and to instead mirror conventional finance by adopting interest-like fixed return instruments is often seen as a failure of Islamic finance to deliver on its original promise of institutionalizing an innovative financial system for bringing about social and economic benefits to the Islamic world. The tendency for Islamic banks to overlook the socio-economic agenda is commonly explained by the early stage of development that Islamic banks are at; the mixed banking systems environment in which they operate where their survival rests on how successfully they compete with their mainstream counterparts; and the many challenges specifically faced by the banks in term of the legal and regulatory framework, political and economic climate, and lack of human infrastructure.

Moreover, the modeling of Islamic banks is based on the structure of commercial banks. The pragmatic approach that the development of Islamic finance has adopted was a result of the realities of the financial markets where economic incentives are prioritized over religious behavioral norms. To remain in existence, Islamic banks are believed to have been forced to adopt the "second best solution" and thus become part of the international financial system (Sairally, 2007:23).

Islamic banking should be concerned with much more than just refraining itself from charging *riba* in its business transactions. It is a system that aspires at making a positive involvement to the fulfillment of the socio-economic objectives of Islamic society as inscribed in *Maqasid Al-Shari'ah* (Dusuki, 2008). However, Zaman and Asutay (2009) argue that the Islamic banking and finance fails to adhere to one of the *Maqasid Al-Shari'ah* which is to safeguard the wealth of the people. This is on the ground that the practice of Islamic banks is economically not feasible. They further explain that the Islamic bank approach leads to products being more costly, and even less accessible to those in need. Moreover, it failed to live up to expectations in terms of providing the uplift in human welfare as it promised (Zaman and Asutay, 2009:89). Thus, as a business entity established within the domain of *Shari'ah*, Islamic banks are expected to fulfill the Islamic economic objectives (*Maqasid Al-Shari'ah*) which is to ensure that wealth is fairly circulated among as many as possible without causing any harm to those who acquired it lawfully (Dusuki, 2008:55).

The most important challenge that all financial systems, including the Islamic, face at present is to be sound and efficient and free from crisis and instability. However, even if the Islamic financial system meets this challenge successfully, it may still not be able to be a genuine reflection of Islamic teachings if it fails to realize the vision of Islam by actualizing justice, alleviate hardship and eliminate prejudice which are the primary objectives of Islam (*Maqasid Al-Shari'ah*). The objectives and wisdom as prescribed by *Shari'ah* in all its rulings is to protect and preserve the benefits and interest (*maslahah*) of society. It may not be possible to realize this vision unless all human institutions, including the financial system, contribute positively towards this end (Chapra, 2007). In addition, according to *Qur'an*, the primary mission for which all the Messengers were sent to this world by God was to establish justice (57:25) and to ensure that wealth does not circulate only among the rich (59:7). Islam also promotes transparency and accountability (2:282) in financial transaction.

Chapra (2008) argues that in spite of progressive taxation and the welfare state, inequalities of income and wealth have continued to rise in most countries around the world. This is because the financial system has continued to promote concentration of wealth. Unless the financial system is based on a proper worldview and tries to ensure justice, it will not be able to promote the well-being of all even though it may promote development (Chapra, 2008b). Hence, this will spread and fertilize the seeds of discontent, social unrest and economic decline.

Thus, some means needs to be considered to enable the poor to get credit for establishing micro enterprises or buying essential goods to fulfill their needs. It should be possible to devise a mechanism that could ensure justice in the financial system by making credit available to a large spectrum of society without promoting financial instability. Furthermore, experience around the world shows that poor people have generally been faithful in their repayments.

A number of countries have, established special microfinance institutions to grant credit to the poor and lower middle class entrepreneurs (Chapra, 2008a:122). It is important that microfinance is provided to the very poor people on humane interest-free basis (*qard al-hassan*). Chapra (2008a) further argue that this may be possible if the micro credit system is integrated with *zakah* and *awqaf* institutions. Nevertheless, microfinance institutions faced a problem of inadequate financial resources. One possible way to solve this problem is to scale up the microfinance sector by integrating it with commercial banks. However, commercial banks do not generally lend to small borrowers because of the higher risk and expense involved in such financing (Chapra, 2008a:122; Dusuki, 2008:51). Dusuki (2008) further elaborates that the risk is more exacerbated due to the inherent difficulty for the commercial financial institutions to diversify their portfolio. Therefore, in order to reduce the risk and expense a subsidy from *zakah* and *awqaf* funds can be supplied for those borrowers who are eligible for *zakah* (Ahmed, 2008; Al-ZamZami and Grace, 2000; Chapra, 2008a:122; Khan, 2010).

The main objective of the institution of *zakah* is to redistribute income in favor of the poor within a community as Islam does not like any form of wealth concentration in a few hands and considers their redistribution. Here, lays the principle of natural justice and equity.

Moreover, the needy and the poor people can improve their living standard through receiving *zakah* money. Hence, with a better condition of life, they will have a higher chance to get a better education and knowledge. This will lead to the development of the Muslim society.

The fact that the primary objective of *zakah* is the achievement of socio-economic justice is not denied. Through *zakah*, there is a foundation for the socio-economic principles of Islamic society and is the binding connection between individual Muslims. Not only it is an act of worship to Allah, *zakah* is also known as the cure for many social ailments that faced by Muslim society today. If the principle of *zakah* is applied, most of the social dilemma such as social injustice, greed, and hatred will diminish and be replaced by an attitude of love, kind, caring and sympathy.

Muslim society need to be developed not only from the material aspect but also from the psychological aspect. Social development is also a crucial thing for Muslim society. These developments should be continuously improved from time to time. Without these developments, Muslim will be left out in many things. Further more, the development of the Muslim society will ensure the survival of it in the future. Thus, *zakah* is seen as one of the tool to ensure the social development in Muslim society. By paying *zakah*, it will indirectly strengthen the relationship among the society. Nevertheless, it will reduce the gap between the rich and the poor.

Ahmed (2008) asserts that the areas in which *zakah* can contribute in the macro-context would be improving the human capital through specific programs for the poor and vulnerable. *Zakah* also has a more significant role to play with regard to poverty alleviation strategies in the micro level such as providing education and skill development, health facilities, social services that improve the welfare of the poor, provision of physical capital (like a taxi, sewing machine, etc.),and making available financial capital to start a business so that the poor can be productively employed to earn a living (Ahmed, 2008).

Another way for Islamic financial institutions can facilitate the socio-economic development of the Muslim *ummah* is through utilizing the concept of *awqaf* in micro financing (Ahmed, 2009; Khan, 2010). Historically, *awqaf* based institutions did provide loans to the disadvantaged person or groups. The *awqaf* microfinance institutions will retain the basic operational format of microfinance institutions, but will have some distinguishing features. For instance, the nature of the *awqaf* fund is to keep the corpus intact. Thus, the simplest option is to invest the *awqaf* endowment in some safe fixed-income asset and use the returns for microfinance operations (Ahmed, 2009). However, this will entail that the scope of microfinance will be limited. Moreover, group-based microfinancing can also be used (as it mitigates the credit risk).

Example of success story of Islamic microfinance organizations is the Hodeidah Microfinance Programme (HMFP) in Yemen. It began in the fall of 1997, after a market study was conducted in the city of Hodeidah, Yemen. The population studied showed a clear preference for the methodologies of Islamic banking in terms of receiving credit. HMFP is the first microfinance project of its kind in Yemen. In spite of this survey, when the programme was first introduced, some clients were afraid to take the loan due to their religious beliefs. Additionally, as financing is not based on profit sharing, the return to the institution is based on a well-defined contract, with predefined amounts. Therefore there is no opportunity for abuse on the part of the client through inaccurate or false record-keeping. Finally a fixed contract and absence of profit sharing implies a less complicated process and thus a lower cost to the institution to implement (Al-ZamZami and Grace, 2000).

A study by Hamid (2005) is involving Islami Bank Bangladesh Limited (IBBL). The bank recently got involved in the development of small entrepreneurs (DSE), through such programmes as Rural Development Scheme (RDS) and Small Business Investment Scheme

(SBIS). There are also microfinance schemes of several other government and non-government financial institutions for DSE, which is regarded as a major instrument of poverty alleviation. Hamid (2005) makes a comparative assessment of the performance of the IBBL programmes, which are *Shari'ah*-based, and microfinance schemes of other institutions, which are interest-based. He also discusses the problems of applying Islamic modes of finance for the rural poor, and, drawing on the experience gained from field surveys, suggests mechanisms to invigorate the role of the IBBL in the development of small entrepreneurs. The paper highlights the role the IB can play in the DSE. It provides an idea about how small entrepreneurs can be developed through an Islamic way. Drawing on the experience gained through field surveys, some mechanisms for invigorating the Islamic bank's role in this area are suggested. It is suggested that field studies, like the one on the basis of which the recommendations are made, should be repeated at regular intervals so that more matured opinions of the clients could be obtained and analyzed (Hamid, 2005).

Another case study was done by Ahmed (2008) also in Bangladesh. He examines the role of *zakah* and macroeconomic policies aimed at growth of income and providing opportunities to the poor in eliminating poverty. Replication of various macro-regimes and *zakah* schemes for Bangladesh reveal that while macroeconomic policies play an important task in lessening poverty, poverty cannot be eradicate without employing *zakah* in a useful way. Ahmed (2008) further argues that there are certain circumstances under which *zakah* will be able to make an effect on poverty. First, *zakah* has to be complimented by vigorous macroeconomic policies that increase growth and also redistribute income to reduce poverty. Second, while more *zakah* has to be collected and disbursed, the impact on poverty will only be significant when a larger percentage of *zakah* proceeds are used for beneficial purposes. Knowing the important role of *zakah* in poverty alleviation, there is a need for countries to incorporate this vital faith-based institution in the development strategy and programs of Muslim countries, including Bangladesh (Ahmed, 2008).

5. Conclusion

This paper endeavors to discuss the need for a socially inclusive financial system and explores the current state of Islamic finance and the *Maqasid Al-Shari'ah*. It also debates the roles of Islamic financial institution can plays to facilitate the socio-economic development for the Muslim societies.

The goal of Islamic banking and finance is to bring greater justice and strive for the realization of the *Maqasid Al-Shari'ah* in order to achieve socio-economic development. Islamic financial system can serve as a tool to foster the economic growth as well as human well-being. Promoting risk-sharing instead of debt-financing, reducing poverty and inequities are the necessary objectives that need to be tackled by Islamic financial institutions.

Islamic financial institutions should continue to generate high profits, reflecting the strong growth prospects of the retail market across the Muslim world. However, special commitment should be considered to promote the socio-economic development through *zakat* and *awqaf* facilities. Thus, it is important for the players in the Islamic banking industry to better position themselves in order to confront and respond vigorously to the robustness of the global financial environment.

Furthermore, in shaping the social and economic development, the strategic direction of the Islamic finance industry moving forward needs to be complemented by the effective execution of the legal, regulatory and supervisory system. This is imperative features to assure Islamic finance is conserved as to retain its inherent resistance and steadiness while achieving it goal to sustain socio-economic growth especially for the Muslim communities, and other communities at large.

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