УДК 336.71:297

Ismail Ozsoy,
PhD (Economics), Prof., Fatih University, Istanbul, Turkiye

ISLAMIC BANKING: CONCEPTUAL FUNDAMENTALS AND BASIC FEATURES

Introduction

According to Islam, the income kinds of profit and/or rental-fee are permissible while the interest income is prohibited.[1] From the Islamic perspective, *interest* (or usury) is an actual or potential excess or surplus without any comparable equivalent in loans or exchanges. This excess or surplus has not any consideration that can be matched with so that it can be regarded as legitimate and rightful earnings. Thus it causes a financial loss to either of two parties.[2]

Interest is of two kinds. First, *interest of loan* (riba al-dain in Arabic), one that appears in loans as a percentage or any fixed payment added to the principle, is the most widespread, and the most debated, kind of interest known by all. Lending money, say €100, at a certain interest rate, say 5%, is the example. Second is *interest of exchange* (riba al-bai' in Arabic), one that appears in exchanges.

The second one -interest of exchange- is also divided into two kinds; one is called *interest of surplus* (riba al-fadl in Arabic) that appears as a quantitative surplus in one of the exchanged goods of the same kind -as in the case when two measures of corn is exchanged for three measures of corn, even if it is due to the difference of quality. And the other is called *interest of delay or deferral* (riba al-nasia in Arabic) that appears in exchanges as a quantitative or potential surplus (value differentiation) when the delivery of one of the goods exchanged is delayed, as in the case when a ton of iron is sold for the same amount of iron on a deferral basis; let alone for a larger amount of delayed iron.

Here, interest arises as a potential value differentiation between two goods -iron for iron- due to the delayed delivery of one of the goods. Time, or term, is a primary reason for the "value differentiation" between the present and future goods exchanged; hence, it causes a potential excess in one of the goods when compared to the other good. Due to the fact that nobody knows in advance for whom and how much this potential surplus proves to be realized, Islam prohibited all the delayed sales or futures.

The exception of the interest of delay is the exchange wherein only one of the items is 'money' since any delayed 'money-for-commodity' or 'commodity-for-money' exchanges do not establish any interest relationship. This is because of the value measuring character of money for commodities, and the need of the people not having cash for pressing demands.

All the futures in the form of forward rate agreements, and exchanges of financial derivatives for each other without corresponding to any real value change in the underlying real assets on which derivative are based, also include interest. For example selling cash €100 for delayed $130 includes interest of delay.

Similarly, exchange of *loan-for-loan* with different quantities or with different interest rates gives way to interest as with the derivatives so widespread in the developed countries, in US particularly. The exception to this is *swap* wherein two loans of the same quantity and of the same term are traded.

Shortly putting, *interest* is a measurable or noticeable imbalance or disproportionate in exchanges or loans for one party to the loss of the other. With its this nature, interest causes economic disparities between individuals, factors of production and even nations, resulting in considerable social and economic problems. These imbalances appear as *bubbles* and crises eventually in the financial markets when they can not be sustained. Though not expressed so far so clearly, interest based transactions are the most effectual reasons of the economic bubbles and their consequences in the form of crises.[3] This is a reason for interest to be banned by all the religions and for its being criticized by most of the philosophers and scholars throughout history.

Interest Theories

The issue of interest has been controversial throughout history. It was banned by the Abrahamic religions Judaism, Christianity and Islam, as well as by all other religions, and criticized by philosophers of the Ancient Times and the Middle Ages. The expansion of commerce and trade to the end of the Middle Ages in Europe required frequent capital borrowing. Due to the need of large sums of capital borrowing, many theories of interest arose to confirm the necessity for interest and

[1] Here, the terms 'interest' and 'usury' (in Arabic 'riba') are definitely interchangeable.
[2] See, Ozsoy, Ismail, "Faiz", I*slam Ansiklopedisi (Islamic Encyclopedia),* Türkiye Diyanet Vakf?, 1995, XII-110-26.
[3] http://en.wikipedia.org/wiki/Economic_bubble, accessed on Nov 27, 2008.

to justify it despite the robust resistance of the Church initially that lasts 1500 years but being tolerant afterwards due to some reasons. Thus, the banking system of the modern times has completely been based on the interest.

However, these theories have failed to explain why interest is paid. This situation has always produced suspicions about the necessity for, and the legitimacy of, interest. To us, all opinions defending interest seem to continue to be inconsistent and incongruous because of the *nature* of the interest that we will explain below.

The common point of nearly all theories of interest is *productivity of capital*. Besides, there is *"time-preference theory"* of Bohm-Bawerk, which states that there is a difference of value between present goods and future goods. In his view, the former are worth more than the latter. The difference between the two must be equalized through interest payment for present goods -namely ready money- to be lent for a certain period. These two points are seemingly the strongest sides of the theories of interest.

Based on mainly these two interest theories, capitalism imagines that potential income of capital -in ready money- is transformed to an actual yield as soon as it is loaned. As for the value differentiation; capitalism requires the debtor to pay a fixed interest to the creditor at the very beginning of lending, deciding that this differentiation will always be against the debtor although it might appear for either side, for the creditor against the debtor, or for the debtor against the creditor.

As for Islam, it does not accept to charge interest at the beginning, realistically taking into consideration dynamism and variability of economic conditions. Because it is impossible to know at the beginning whether or not the potential income in capital will realize actually, and to estimate how much it will be even if it does.

Quranic Approach to Interest

Then, the most important reason for interest to be forbidden by Islam and the only reason the Quran particularly mentions thereabout can be stated as following:

"Interest is prohibited due to the fact that either the borrower or the lender would absolutely and inevitably be subjected to an injustice in any case, for its rate is fixed at the very beginning, although it is impossible to predict the outcome, profit or loss, or how much either would be."

"If you persist in interest based transactions" says the Quran, *"Either you will wrong, or you will be wronged."*[4]

Thus, it is clear that Quran identifies interest with *injustice*, that is unfair and unequal distribution of income. Any interest rate, low or high, is a reason for unjust and unequal sharing of the outcome of the business. Because, while high interest rates in hard economic conditions may cause the borrower to go bankrupt, low interest rates in good economic conditions cause the lender to undergo an injustice.

It is never possible for mankind to find a fair interest rate for any time and for any sector of the economy since man can not see the future outcome of the business, thus there will be a *"deviation"* —that hurts either the borrower or the lender- between the *"initially determined interest rate"* and *"finally realized outcome"*, whereby causing an injustice to either borrower or the lender.

Once this very feature of interest is recognized, we can resolutely claim that it is impossible for any religion, philosophy, economic or political theory to agree with interest policy if they favor the fair distribution of income. Here we can resemble the interest mechanism to a two-bladed saw, or a knife, that cuts on both sides, on one occasion it is the lender who is injured and the borrower on the other occasion, but either side is unavoidably damaged by the interest mechanism.

So, we can say that the prohibition of interest by Islam has its origins in the ultimate sensitivity of the Quran to 'right' and its protection, with a vision of embracing both interest payer and receiver.

The discussion throughout history of distinguishing between interest, which is favored by many, and usury, which is rejected by all, does not make any sense to us. Because, while any high rate of interest damages the borrower in hard economic conditions, any low rate damages the lender in favorable economic conditions where return on capital is high. That is why we can not take interest and usury separately.

Usury is condemned throughout history to be exorbitant and excessive and thus disapproved by almost everybody. Yet, is not a high interest rate (so-called usury) closer to justice in the favorable economic conditions where return on capital is very high than a low interest rate that is favored by many? Hence, so called a reasonable interest rate is as much exposed to criticism as usury. It means that it is not logical to exclude usury from interest, or interest from usury, since both have the same effect -the effect of injuring either of the two parties-.

Time Value of Money

As for differentiation of value, it is called today *'time value of money'* and used to justify the interest. Time value of money is based on the premise that an investor prefers to receive a payment of a fixed amount of money today, rather than an equal amount in the future, all else being equal.[5] Thus, according to Böhm-Bawerk, in order

[4] Qur'an, Baqara, 279.

[5] http://www.statemaster.com/encyclopedia/Time-value-of-money, accessed June 20, 2009.

to persuade a money holder to lend €100 today for one year time, s/he must be offered to be paid back, for instance, €110 since €100 of today is equal in value to €110 of one year later. Here, €10 is claimed to be one year time value of money.

>From the Islamic perspective, money is not taken as a commodity, to be sold and bought, in order to keep the economy from turning to fully a primitive barter system, one in which money is included as another commodity together with other goods. Money is definitely distinguished from the commodities for its being a unit of value measure for all other goods. It is a unit of measure like measures of weight and length. Thus, its value should not change day-to-day like elastic materials that stretch or shrink by the time as with other units of measure, for example, as one meter is 100 cm as well as one kg is 1000 gr. all the time. Its value is not measured by other things, but it always measures all other goods, except the inflationary cases where its value is restored by indexing it to a group of goods. So, 100 lira should be exchanged for 100 lira today and tomorrow if it is a unit of value to measure other things, not a commodity to be measured by other measures.

Therefore, we had better change the term 'time value of money' to the *'time value of goods'*, which are measured by money for the sake of monetary economy. This is because money is not any thing itself; its value is derived from the commodities it represents, except the case when it is a commodity-money like gold and silver. If somebody wants to make money out of money, s/he should not only deal with it, but correlate any monetary transaction with a real asset, i.e. a commodity of which value changes according to the daily supply and demand conditions, thereby making a profit or a loss.

It should be noted here that, while the value of any currency as a unit of measure should not change by the time, its value changes of course compared to other currencies. That is why exchange rates of different currencies frequently change.

In fact, the value differentiation between the present goods and the future goods is pointed out by the Prophet Muhammad fifteen centuries ago who therefore prohibited delayed sales saying,

"Sell gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt — like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand."[6]

Based on the time value of money; capitalism requires the debtor to pay a fixed interest to the creditor, deciding at the very beginning of lending that this value differentiation will always be against the debtor; although it might appear for either side, -for the creditor against the debtor or for the debtor against the creditor-.

As regards the position of Islam that is based on the saying of the Prophet Muhammad on the differentiation of value, it does not agree to set a price for 'time' during which a sum of money is loaned, or a due payment is postponed to a future time, since it is not possible to know what 'time' will bring for either side. This is because a great importance is attached to the value equality between the two items that are exchanged. In this respect, a ready €100 can not be exchanged for a delayed €110 for it is impossible to foresee the future and to forecast the outcome of the business at which a loan with a fixed interest is used. Hence, these two amounts may not be equal in value at the maturity; it is probable that €100 of today may turn to have the value of €90 next year due to the revaluation of that currency; there may be a negative time preference instead of positive one. For instance, it might be better to have 90 m^3 natural gas for heating now in the winter than having 100 m^3 in the coming summer. Likewise, a refrigerator, now in the winter, may be worth less than it will be in the summer to come. As seen, not always the present goods are more valuable than the future ones and it is not possible to determine the exchange rate between them.

Likewise, since it is impossible to predict for which side (for the creditor or the debtor) the value differentiation would appear, Islam has forbidden all delayed sales in order to protect the financial rights of both sides. Thus, while a ton of iron can be exchanged today for 100 packs of cement at the market price, the same exchange is not permitted in case one of the two goods is delayed. Nor the two goods of the same kind are allowed to be exchanged because of the possibility of value differentiation in one of the two goods, even if they are of the same amount. Thus, a ton of coal in summer can not be exchanged for the same amount of coal to a term in winter, let alone for an excess amount of it.

Financial Bubbles

A more important example that can be suggested to have given way to the financial bubble after the burst of which the 2008 Global Financial Crisis occurred is the sale of, say, a financial certificate of $100 with 10% rate of interest and 1 year time for a higher amount and/or for a higher interest for two years time. Thus, a financial

[6] Muslim, Abu'l-Husain b. al-Hajjaj. (1955). Al-Jami' al-Sahih, ed. M. Fuad Abdulbaqi, 1. ed., 1374/1955 (in Arabic), Kitab al-Musaqat, 81. Similar hadiths (sayings) of Prophet Mohammad are available at http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/muslim/010.smt.html [accessed on 16 November 2009] and at http://www.financeinislam.com/article/10/1/552 [accessed on 16 November 2009].

bubble is built if the nominal increase in the value of the financial certificate is not balanced with a real value increase in the underlying assets upon which the financial certificates or derivatives are based.

In short, because it is not possible what 'the time' brings in the future, any exchange on a deferred basis is not allowed in Islam in order to avoid any financial loss that may arise on behalf of either side while capitalism seems to favor only the creditor.

There is an exception to that prohibition: Islam does allow sales in which one of the two items exchanged is 'money' as is the most part of the daily trade transactions. This is so for several reasons. *First*, people need for delayed sales because they may not have a ready purchasing power -cash money- while the need for good or service to be bought is urgent and pressing. *Second*, common reliance is placed upon money as a unit of measure of value more than on other units of measure. Thus, while people do not consent to measure the value of any commodity with another commodity, they agree to do this with money due to its being a standard value unit. *Third*, people are indifferent to the differentiation of value between 'money' and 'goods' because of their being of different kinds, and because market conditions may cause commodity prices to change any time.

Similar to interest, Islam prohibits gambling, a zero sum game where one party loses while the other gains, and any trade where one of the items traded is uncertain, that is called gharar, in order to protect both buyer and seller. Gharar is the sale of probable items whose existence or characteristics are not certain, due to the risky nature that makes the trade similar to gambling.[7] Specific examples of gharar transactions are e.g., selling the birds in the sky or the fish in the water, the catch of the diver, an unborn calf in its mother's womb etc.

Comparison of Interest with Rent

Say, one has a sum of money, who wants to make money out of it. What is the difference between "the interest income" he gets by lending his money at interest and "the rental" he gets by leasing a house he has bought with the same money?

The element of differentiation between *interest income* and rental-fee depends on the fact that if the thing is non-consumable and capable of being used without changing its essence and without damaging its intactness, the benefit received from it would be a good consideration for the rental-fee. This benefit may be a service rendered by persons or a usufruct[8] (right to use) of things.

On the other hand, where the borrowed/rented thing is consumable and perishes when it is used, -as in the case of money, food, and drink-, the rental paid for the use would be in excess of what is owing, that is the principal, by the lessee. This excess so paid is interest, regardless of the fact that it is called 'rental'.[9] This is because the advantage of the rented thing -which is non-consumable- is certain, for it is always ready to be used in any case, and it is strongly possible for it to be handed over by the lessee[10] to the lessor.[11]

Comparison of Interest with Profit

As for the relationship between *interest* and *profit*; profit is a surplus to assets, shared between capital and entrepreneur, resulting from investing a certain amount of money in an economic activity such as agriculture, industry and commerce, and then it is re-transformed whether into a larger sum (where profit is realized) or, a lesser sum (where actual loss is suffered). Thus, profit and loss are twins.

Profit is a result and consideration of an actual supplement and contribution to the revenue of the community by capital coupled with entrepreneur. When the owner of capital participates in a business only with his capital, he has to take risks of loss in that business to deserve a profit. Therefore, profit can be seen as the return for bearing risk. For, after all, business is subject to failure; so in profit, the principle is: *"nothing ventured, nothing gained"*.

One of the elements that make profit permissible is its being a *ratio* of the 'realized positive outcome' at the end of the business, not the 'rate of return on the loan' itself that is predetermined as in the case of interest. While profit is a result of a positive result, interest has nothing to do with the result of the business regardless it is a positive or a negative sum game.

In profit, when the investment results in a loss, the owner of capital is directly affected by it, whereby the community is affected indirectly. But, interest is an income given to money loaned, in any case, even when it does not add any value to the assets, or revenue, of the community.

[7] El Gamal, Mahmoud Amin. (2000). A Basic Guide to Contemporary Islamic Banking and Finance. Rice University. June 2000, http: //www.witness-pioneer.org/vil/Books/MG_CIBF/chapter_1.htm, accessed on Nov. 20, 2008.

[8] Usufruct is the right of using and enjoying the profits of an estate or other thing belonging to another without impairing the substance. In other words, it is a legal right to use and enjoy the profits of any property belonging to someone else provided that the property itself is not injured or damaged in any way.

[9] Homoud, op. cit. p. 133-34

[10] A person who has use of a building, an area of land, etc. on a lease.

[11] A person who gives sb the use of a building, an area of land, etc. on a lease.

In interest, when there is a loss, capital is not affected by it, although that loss directly concerns the capital itself and all the community is affected by it. That is to say, interest income may be earned at the expense of all others in the society. Interest may be 'taking without giving' while profit is made only when the capital contributes to the community and *in proportion* to its contribution.

Interest-free Banking: From Theory to Practice

Although Islam prohibits the option of interest in the business life, it offers a wide variety of many other options in a way that there is not need left to interest any more in order to carry out all kinds of economic activities, and interest-free banking in particular.

In Islamic economics, interest is substituted with profit, rental, commission, and wage, all of which are regarded as legitimate earnings of trade, its derivatives, joint venture and partnerships, leasing, and other lawful and *real* economic activities. So many kinds of sale and equity participation with its many alternatives, which are precisely defined in the Islamic law books, can be said to be enough to meet the needs of the modern communities. Moreover, there is no limit to devising and formulating new methods provided they are cleared of interest.

Here, Islamic banking is a system of banking that is consistent with Islamic economics that prohibits interest as well as investing in unlawful businesses such as alcohol, pork, pornography, and gambling, etc. Although Islamic economics favours a genuine free market where prices are freely determined by supply and demand, profit maximization in Islamic banking and other economic activities is only limited by social and moral values. Therefore Islamic banking is multi-purpose and not purely commercial and it is strongly equity-oriented.

Islamic banks differ from the traditional banks in that they operate according to the principles of Islam; they trade in commodities not in money; and there is more to Islamic banking than maximizing the profit in contrast to the traditional banks as it aims to contribute towards a more equitable distribution of income and wealth, and increased equity participation in the economy (Chapra, l982). Apart from traditional banks and financial institutions with their character of mostly lending, Islamic banks are either trader, or lessor or partner in business transactions.

Profit and loss sharing *(mudaraba)* and equity participation *(musharaka)* are the most favored modes of finance of Islamic banking. Mudaraba is an arrangement between a capital provider and an entrepreneur, whereby the entrepreneur can mobilize funds for its business activity. The entrepreneur provides expertise and management and is referred to as the *Mudarib*. Any profit made is shared between the capital provider and the entrepreneur according to a pre-agreed ratio. Supply of, and demand for, capital and enterprise are the basic determinant of this ratio besides the bargaining power of the parties. Only capital provider bears any capital loss if occurred while the entrepreneur bears the loss of his labor since he has toiled for nothing.

Participatory arrangements between capital and labor, as in the case of mudaraba, reflect the Islamic view that it should not be only the borrower who bears all the risks and costs of a failure in business, resulting in a balanced distribution of income and not allowing lender to monopolize the economy as with the most outstanding outcome of interest mechanism.

Musharaka (joint venture or equity participation) is a partnership contract by the mutual consent of the parties for sharing of profits and losses in a joint business. Here, the bank provides funds, which are mixed with the funds of the business enterprise, and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.

In equity participation (musharaka) or in a profit and loss sharing (mudaraba), what makes profit permissible is the profit-sharing *ratio* of the *realized positive outcome* at the end of the business, not the rate of return on the loan itself that is predetermined in the case of interest. While profit is a result of a positive result of the business and in proportion to it, interest has nothing to do with the result of the business regardless it is a positive or a negative sum game.

Islamic banks normally operate three broad categories of account, mainly current, savings, and investment accounts. The current account, as in the case of conventional banks, gives no return to the depositors. It is essentially a safekeeping *(alwadiah)* arrangement between the depositors and the bank, which allows the depositors to withdraw their money at any time and permits the bank to use the depositors' money. Cheque books are issued to the current account deposit holders. Islamic banks provide the broad range of payment facilities clearing mechanisms, bills of exchange, travelers' cheques, credit/bank cards etc.

The savings account is also operated on an *al-wadiah*[12] basis, but the bank may pay the depositors

[12] Al-wadiah is safe-keeping with guarantee. It refers to money or goods deposited with another person for safe-keeping. As al-wadiah is a trust, the depository guarantees repayment of the whole amount of the deposit when demanded. The depositors are not entitled to any share of the profits but the depository may provide returns to the depositors as a token of appreciation.

a *positive* return periodically at its absolute discretion, depending on its own profitability. Such payment is considered lawful in Islam since it is not a condition for lending by the depositors to the bank, nor is it predetermined. The savings account holders are issued with savings books and are allowed to withdraw their money as, and when, they please. (Ariff, 1988, 51)

The investment account is based on the *mudaraba* principle, and the deposits are term deposits which cannot be withdrawn before maturity. If withdrawn, no profit is paid. The profit-sharing ratio varies from bank to bank and from time to time depending on supply and demand conditions.

At the investment portfolio end of the scale, Islamic banks employ a variety of instruments. The *mudaraba* and *musharaka* modes are supposedly the main channels for the outflow of funds from the banks. In practice, however, Islamic banks have shown a strong preference for other modes which are less risky. The most commonly used mode of financing seems to be the 'mark-up' device which is termed murabaha.

In a *murabaha* transaction, the bank finances the purchase of a good or asset by buying it on behalf of its client and adding a mark-up before reselling it to the client on a 'cost-plus' basis. It may appear at first glance that the mark-up is just another term for interest as charged by conventional banks, interest thus being admitted through the back door.

What makes the *murabaha* transaction legitimate is that the bank first acquires the asset and it assumes certain risks in the process between purchase and resale. The bank takes responsibility for the good before it is safely delivered to the client. The services rendered by the Islamic bank are therefore regarded as quite different from those of a conventional bank, which simply lends money to the client to buy the good, and which is mostly not interested in how and where the loan is used other than securing the return of the loan with some measures such as collaterals and mortgages.

Leasing or *ijara* is also frequently practiced by Islamic banks. It means selling benefit or use or service for a fixed price or wage. Under this mode, the banks would buy the equipment or machinery and lease it out to their clients who may opt to buy the items eventually, in which case the monthly payments will consist of two components, i.e., rental for the use of the equipment and installments towards the purchase price.

Islamic banks have also been resorting to purchase and resale of properties on a deferred payment basis, which is termed bai' *muajjal*. It is considered lawful in fiqh (jurisprudence) to charge a higher price for a good if payments are to be made at a later date. According to Islamic law, it is not interest, since it is not a lending (money-for-money) transaction but a trading one (money-for-goods). Here, the higher price corresponds to the earlier use value of the property by the client rather than saving money first for a period of time and then buying the property on his behalf, thus having to postpone the use value of it.

A pre-paid purchase of goods, which is termed *salam*, is a means used to finance production by Islamic banks. Here the price is paid at the time of the contract but the delivery takes place at a future date. This mode enables entrepreneurs to sell their output to the bank at a determined price in advance.

Similar the salam, but more extended than it, *istisna'a* is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery. It can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, and building of bridges, roads, and highways.

These are basic modes of Islamic banking. Similarities with conventional banking are only superficial resemblances since Islamic banking is necessarily based on real businesses. Notwithstanding the areas of operation, differences lie in the modes of transactions and their associated practical arrangements. For example, whereas an Islamic bank may charge a fixed markup in murabaha financing, the thing provided may not be repossessed, payment delays/defaults will not justify any compensatory claims, and the client may not claim rebates for early settlement. Of course, the bank can make recourse to some covers in order to protect its financing.[13]

These modes of Islamic finance, especially mudaraba, were practiced predominantly in the Muslim world throughout the Middle Ages, fostering trade and business activities. In Spain and the Mediterranean and Baltic States, Islamic merchants became indispensable middlemen for trading activities. It is claimed that many concepts, techniques, and instruments of Islamic finance were later adopted by European financiers and businessmen.[14] The commenda of the Medieval Europe was originally the Muslim mudaraba contract as forcefully

[13] Tahir Sayyid.(2007). "Islamic Banking Theory and Practice: A Survey and Bibliography of the 1995-2005 Literature". Journal of Economic Cooperation, 28,1 (2007), p. 21.

[14] http://www.islamic-banking.com/ibanking/whatib.php, accessed on Oct 10, 2008.

argued by Udovitch,[15] and by Ashtor.[16] As a form of partnership, the commenda was most common in the sea trade of the Mediterranean, but it was also used in overland travel. In Genoa and other Italian cities, as early as the twelfth century many individuals who were not actually active in trade invested in trade by this means.[17]

A recent International Monetary Fund study by Iqbal and Mirakhor (l987) has found Islamic banking to be a viable proposition that can result in efficient resource allocation. The study suggests that banks in an Islamic system face fewer solvency and liquidity risks than their conventional counterparts.[18]

Islamic banking is steadily moving into an increasing number of conventional financial systems. Today, Islamic banking is estimated to be managing funds to the tune of US$ 200 billion.[19] According to another estimate, the volume of Islamic financial assets has reached US$ 500 billion, even to another it is US$ 750.[20] Its clientele are not confined to Muslim countries but are spread over Europe, United States of America and the Far East. Islamic banking continues to grow at a rapid pace because of its value-orientated ethos, which enables it to draw finances from both Muslims and non-Muslims alike. Islamic bankers, keeping pace with sophisticated techniques and latest developments have evolved investment instruments that are not only profitable but are also ethically motivated.

In fact there are currently more than 300 Islamic financial institutions operating world-wide and spread over more than 50 countries including non-Muslim as well as Muslim countries, plus well over 250 mutual funds that comply with Islamic principles. A mutual fund is an investment company that pools the money of many individual investors to purchase stocks, sukuk or other financial instruments. Over the last decade, this industry has experienced growth rates of 10-15 percent per annum -a trend that is expected to continue.[21] The size of the total Islamic financial assets is estimated to reach US$ 1 trillion.[22]

The countries where Islamic financial institutions are functioning include: (in alphabetical order) Albania, Algeria, Australia, Bahamas, Bahrain, Bangladesh, British Virgin Islands, Brunei, Canada, Cayman Islands, North Cyprus, Djibouti, Egypt, France, Gambia, Germany, Guinea, India, Indonesia, Iran, Iraq, Italy, Ivory Coast, Jordan, Kazakhstan, Kuwait, Lebanon, Luxembourg, Malaysia, Mauritania, Morocco, The Netherlands, Niger, Nigeria, Oman, Pakistan, Palestine, Philippines, Qatar, Russia, Saudi Arabia, Senegal, South Africa, Sri Lanka, Sudan, Switzerland, Tunisia, Turkey, Trinidad & Tobago, United Arab Emirates (Abu Dhabi, Dubai, Sharja), United Kingdom, United States, Yemen.[23] Similarly, countries like India, the Kyrgyz Republic, and Syria have recently granted, or are considering granting, licenses for Islamic banking activities.[24]

Conclusion

The issue of interest is a complication to all the economies and a problem for all the mankind. Since it is naturally a reason for an unavoidable inequitable distribution of income in any interest bearing transaction, Quran explicitly identifies interest with injustice either for borrower or lender and rejects it as a way of income distribution

Interest is an *unearned income* when realized rate of return is lower than initially determined interest rate and an *unequally distributed income* when realized rate of return is unexpectedly higher than initially determined interest rate. Since a middle way that both parties are equally satisfied is one of too many probabilities, any interest rate, like a both-sided cutting saw, is a reason for an unavoidable financial loss for either party; therefore it is prohibited by Quran in order to protect financial rights of borrower and lender in an all-embracing manner.

Interest also represents the allocation of an *imaginary income*, which is assumed to have been born out of the

[15] Udovitch, A. L. (1962). "At the Origins of the Western Commenda: Islam, Israel, Byzantium", Speculum 37, pp. 198-2007. See also, Cizakca, Murat. 196). A Comparative Evolution of BusinesPartnerships, the Islamic World and Europe with Specific Reference to the Otoman Archives, Leiden: E. J. Brill.

[16] Ashtor, E. (1977). "Banking Instruments between the Muslim East and the Christian West", Jounal of European Economic History, 1977/1, pp. 553-3.

[17] Cameron, Rondo.(1997). A Concise Economic History of The World, 3rd Ed., Oxford University Press, p. 67.

[18] Ariff, Mohamed. (1988). "Islamic Banking", *Asian-Pacific Economic Literature*, Vol. 2, No. 2 (September 1988), p. 55, available at http://www.witness-pioneer.org/vil/Articles/economics/islamic_banking.html#litpra, accessed on Oct 10, 2008.

[19] http://www.islamic-banking.com/ibanking/ifi.php, June 20, 2009.

[20] Katilim Bankalari 2008 (Participatory Banks 2008). Turkiye Katilim Bankalari Birligi (Association of Participatory Banks of Turkey), Istanbul, p. 30.

[21] Solé, Juan. (2007). "Introducing Islamic Banks into Conventional Banking Systems" IMF Working Paper, Monetary and Capital Markets Department, July 2007, WP/07/175, p. 3.

[22] Katilim Bankalari 2008, ibid.

[23] http://www.islamic-banking.com/ibanking/statusib.php accessed on Oct 10, 2008.

[24] Solé, ibid.

exchanges of the derivatives on the basis of their nominal values. Thus, the main reasons for the recent financial bubble that resulted in the Global Financial Crisis of 2008 can be said to be the interest bearing transactions, in the Islamic sense, of the financial derivatives.

That unacceptable nature of interest has given way to the introduction and development of Islamic banking based on so many substitutions for interest available in Islamic economics.

In Islamic economics interest is replaced with so many other options based on the kinds of participation, trade, exchange, and leasing in a way that no need is left to interest. Thus, interest income is substituted for profit, rental, wage, commission; each having a concrete consideration of value in the economic sense in contrast to interest that has not any comparable equivalent in loans or exchanges.

With a different function depending on the client's situation Islamic bank sometimes acts as trader and provides capital financing through the salam or istisna' modes, and recover its financing by having standing arrangements with final buyers for things produced in the name of the bank against the financing. It may adopt the option of ijara if the client is interested in leasing an asset. It can provide financing on partnership basis - mudaraba or musharaka.

Islamic banking mostly favors the modes of profit loss sharing and equity participation. However, since these modes of business activities demand such humanistic/ ethical values as trust, honesty, integrity and professionalism, they are the limits to the ultimate success of interest free banking in all societies.

Even in its present form that prefers risk free or less risky kinds of transactions, Islamic banking can be taken as a considerable step and an opportunity for the whole mankind towards a more equitable world. This is because Islamic banking, with its interest-free and real value based character, does not seem to create at least financial bubbles the interest mechanism has caused recently, and may cause any time; the bubbles that, once they can not be sustainable and burst eventually, shake all the global markets. It has something to give all.

The attachment of Islam to the equal distribution of income by prohibiting the interest, one of the most influential reasons for the unequal distribution of income and the discouraged investment, can be said to help alleviate the problem of poverty since the equal distribution of income causes the aggregate demand to increase, which gives way to an increase in the aggregate supply, aggregate output and employment. Moreover, crisis-preventive nature of interest-free policies contributes to the economic stability and the common welfare.

More importantly, Islamic banking can be a bridge between the Western communities and the Muslim societies, thereby contributing to the world peace as well as the common welfare. The roots of this cooperation are available in the common origins of the Jewish, Christian and Islamic traditions that prohibit interest. Resisting the interest for 1500 years, longer than the lifetime of Islam since its birth, the Vatican accomplished its historic mission by referring to the Islamic banking system to the current western financial world,[25] which can be regarded as the beginning of a new age when the whole mankind can expect a better future in terms of peace and socio-economic welfare for all.

References

1. **Al Gamal**, Mahmoud Amin. (2000). A Basic Guide to Contemporary Islamic Banking and Finance. Rice University. June 2000. 2. **Ariff Mohamed.** (1988). "Islamic Banking", *Asian-Pacific Economic Literature*, Vol. 2, No. 2 (September 1988), pp. 48-64, available at http://www.islamicity.com/finance/IslamicBanking_Evolution.htm. 3. **Ashtor E.** (1977). "Banking Instruments between the Muslim East and the Christian West" // *Jounal of European Economic History*. — 1977/1. — pp. 553-3. 4. **Böhm-Bawerk Eugen**. (1897). "The Origin of Interest", *Quarterly Journal of Economics*, vol. 10, available at http://socserv.mcmaster.ca/econ/ugcm/3ll3/bawerk/interest.htm, June 17, 2009. 5. **Cameron Rondo**.(1997). A Concise Economic History of The World, 3rd Ed., Oxford University Press. 6. **Chapra M. Umer.** (l982). "Money and banking in an Islamic economy" in Monetary and Fiscal Economics of Islam, ed. M Ariff, International Centre for Research in Islamic Economics, Jeddah. 7. **Cizakca Murat.** 196). A Comparative Evolution of BusinesPartnerships, the Islamic World and Europe with Specific Reference to the Otoman Archives, Leiden: E. J. Brill. 8. **Homoud Sami Hassan.** (1985). Islamic Banking: The Adaptation of Banking Practice to Conform with Islamic Law, Arabian Information Ltd, Cambridge University Press, London. ISBN: 0-86010-503-2. 9. http://en.wikipedia.org/wiki/Economic bubble, accessed on Nov 27, 2008. 10. http://www.islamic-banking.com/ibanking/ifi.php, June 20, 2009.

[25] "Vatican backs Islamic finance", available at http://www.newhorizon-islamicbanking.com/index.cfm?section=news&action=view&id=10751, May 20, 2009; "Vatican offers Islamic finance system to Western Banks", March 6, 2009, available at http://www.worldbulletin.net/news_detail.php?id=37814, May 20, 2009; "Vatican Paper Supports Islamic Finance. France Wants Its Share of Sharia Banking", available at http://www.brusselsjournal.com/node/3819, May 20, 2009.

11. http://www.islamic-banking.com/ibanking/statusib.php, accessed on Oct 10, 2008. 12. http://www.islamic-banking.com/ibanking/whatib.php, accessed on Oct 10, 2008. 13. http://www.statemaster.com/encyclopedia/Time-value-of-money accessed June 20, 2009. 14. **Katilim Bankalari** 2008. (Participatory Banks 2008). Turkiye Katilim Bankalari Birligi (Association of Participatory Banks of Turkey), ?stanbul (in Turkish) (www.tkbb.org.tr). 15. **Muslim Abu'l-Huseyn b. al-Hajjaj.** (1955). Al-Jami' al-Sahih, ed. M. Fuad Abdulbaki, 1. ed., 1374/1955 (in Arabic). 16. **Ozsoy Ismail**. (1995). "Faiz (Interest)", *Islam Ansiklopedisi (Islamic Encyclopedia)*, Türkiye Diyanet Vakfı, Vol: XII-110-26 (in Turkish). 17. **Solé Juan.** (2007). "Introducing Islamic Banks into Conventional Banking Systems" IMF Working Paper, Monetary and Capital Markets Department, July 2007, WP/07/175, available at http://www.imf.org/external/pubs/ft/wp/2007/wp07175.pdf, accessed on Nov 30, 2008. 18. **Tahir Sayyid.** (2007). "Islamic Banking Theory and Practice: A Survey and Bibliography of the 1995-2005 Literature", J*ournal of Economic Cooperation*, 28,1 (2007), 1-72. 19. **The Holy Quran**. 20. **Udovitch A. L.** (1962). "At the Origins of the Western Commenda: Islam, Israel, Byzantium", Speculum 37, pp. 198-2007. 21. "Vatican backs Islamic finance", available at http: //www.newhorizon-islamicbanking.com/index.cfm?section=news&action=view&id=10751, May 20, 2009. 22. "Vatican offers Islamic finance system to Western Banks", March 6, 2009, available at http://www.worldbulletin.net/news_detail.php?id=37814, May 20, 2009. 23. "Vatican Paper Supports Islamic Finance. France Wants Its Share of Sharia Banking", available at http://www.brusselsjournal.com/node/3819, May 20, 2009. 24. **Wikipedia** contributors, "Economic bubble," Wikipedia, The Free Encyclopedia, http://en.wikipedia.org/w/index.php?title=Economic_bubble&oldid=253257201 (accessed November 27, 2008). 25. **Wikipedia** contributors, "Islamic banking," Wikipedia, The Free Encyclopedia, http://en.wikipedia.org/w/index.php?title=Islamic_banking&oldid=170724439 (accessed November 13, 2007).

Ismail Ozsoy. Islamic banking: conceptual fundamentals and basic features

Islamic banking is a phenomenon of the finance and banking world in the recent decades. Rejecting interest policy as an instrument for any business activity, Islamic banking is based on the substitutions for interest that are profit, rental, commission, and wage, all of which are regarded as legitimate earnings of trade, its derivatives, joint venture and partnerships, leasing, and other lawful and real economic activities. Before explaining the interest free finance and banking methods, this paper first criticizes the interest policy, tries to uncover its nature, and its prohibition reason by the Quran. Then, it makes brief 'interest-rental' and 'interest-profit' comparisons. The paper also deals with the foundations and some basic characteristics of Islamic banking together with its practical appearances in the world.

Key words: interest/usury, Islamic/interest-free banking.

Ісмаїл Озсой. Мусульманська банківська справа: концептуальні принципи та особливості

Мусульманська банківська справа — явище, що набуло поширення у фінансовому та банківському світі в останні десятиліття. Відкидаючи вигідний поліс, як інструмент для будь-якої ділової активності, Мусульманська банківська справа заснована на замінах для інтересу у вигляді доходу, рентного доходу, комісії, заробітної плати, що розцінюються як законна виручка від торгівлі, спільних підприємств і товариств, оренди та іншої законної і реальної господарської діяльності. Автор статті критикує вигідний поліс, намагається розкрити його природу та причину заборони кораном.

Ключові слова: інтерес/лихварство, Мусульманське/безвідсоткове банківське діло.

Исмаил Озсой. Мусульманское банковское дело: концептуальные принципы и особенности

Мусульманское банковское дело — явление, получившее распространение в финансовом и банковском мире в недавние десятилетия. Отвергая выгодный полис как инструмент для любой деловой активности, Мусульманское банковское дело основано на заменах для интереса в виде дохода, рентного дохода, комиссии, и заработной платы, которые расцениваются как законная выручка от торговли, совместных предприятий и товариществ, аренды и другой законной и реальной хозяйственной деятельности. Автор статьи критикует выгодный полис, пробует вскрыть его природу, и причину запрещения кораном.

Ключевые слова: интерес/ростовщичество, Мусульманское/беспроцентное банковское дело.

Received by the editors: 18.10.2010
and final form in 01.12.2010