



## FUNDAMENTALS OF ISLAMIC ECONOMY AND FINANCE: THEORY AND PRACTICE

### İSLAM EKONOMİSİ VE FİNANSININ TEMELLERİ: TEORİ VE UYGULAMA

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#### ÖZ

Bu makale, İslam ekonomisi ve finansının temel ilkelerini incelemektedir. Karma mülkiyet, belli bir sınır içinde ekonomik özgürlük ve sosyal adalet, İslam ekonomisinin temelleridir. Bu ilkeler ancak zekat ve faizin yasaklanması gibi kurumsal reformlar yoluyla yürürlüğe konulabilirler. Katılımcı finansmanın kâr ve zararın paylaşımı prensibine dayalı faizsiz bankacılık sistemi, İslami finansın merkezinde yer almaktadır. İslami bankacılık, geleneksel bankacılık sistemine üstün bir alternatif olarak önerilmesine rağmen, uygulamada beklentileri karşılayamamıştır. Bunun nedeni, İslam ekonomisi ve finansı lehindeki tartışmanın esas itibarıyla iktisadi olmaktan çok dünyanın çeşitli bölgelerindeki Müslüman kimliğini korumaya yönelik olmasıdır. Türkiye'nin İslami finans deneyimi, 1980'lerin ortasında finansal liberalleşme politikasının bir parçası olarak başlamıştır. Ne var ki, İslami finans ve bankacılık bugüne kadar istenen gelişme düzeyine ulaşamamıştır.

**Anahtar kelimeler:** İslam ekonomisi, İslami finans, İslami bankacılık, katılımcı finansman, kâr ve zarar paylaşımı, İslami finansal araçlar.

#### ABSTRACT

This paper examines the basic principles of Islamic economy and finance. Multi-faceted ownership, economic freedom within a certain limit, and social justice are fundamentals of Islamic economics. These principles can only be implemented through the institutional reforms such as zakat and prohibition of interest. Interest-free banking based on the principle of profit and loss sharing of participatory financing is at the center of Islamic finance. Although it is proposed as a superior alternative to conventional banking system, Islamic banking could not live up to expectations in practice. It is because rather than being essentially an economic one, the argument in favor of Islamic economy and finance was to protect Muslim identity in various parts of the world. Turkey's experience with Islamic finance began in the mid 1980s as a part of financial liberalization policy. Yet the Islamic banking and finance could not achieve the desired level of development till now.

**Key words:** Islamic economy, Islamic finance, Islamic banking, participatory financing, profit and loss sharing, Islamic financial instruments.

## **1. Introduction**

Economics is a social science. What to produce, how to produce, and for whom to produce are the main questions of economics. Each economic system provides different solutions to these problems. There are several schools of thought on how these questions are answered or how these functions are carried out. These schools vary from neoclassical economics to Marxian economics, of which the Keynesians and the monetarists were the famous ones until 1970s. New classical school and new Keynesian school are the popular ones in recent years. Although philosophical, ethical, and religious origins of these widely accepted schools of thought can be discussible, there are some less known schools as well. Amongst them Islamic economics, by its very religious character and appearance, is the most important and influential one.

The purpose of this essay is threefold: First, to provide an overview of the basic principles of Islamic economics and finance. Second, to examine the factors motivating the development of Islamic economy and finance in the world. Third, to evaluate the recent performance of Islamic economy and finance in practice.

The paper is organized as follows. In the first section, basic principles of Islamic economic doctrine, its emphasis on communal values and social justice, and major institutional elements necessary to establish an Islamic economic order are explained. In the second section, the roles of money and finance in Islamic economics are studied, Islamic banking system is compared with conventional banking system, and Islamic financial instruments are introduced. In the third section, institutional, moral, ideological and other factors, which influenced the development of Islamic economy and finance, are discussed. In the fourth section, recent developments in the area so-called Islamic economy and finance are surveyed and the Turkish experience is summarized. In the fifth section, some comments are made on the application side of the Islamic economy and banking over the last quarter of the twentieth century. This section also includes a short quantitative evaluation of the Turkish case. In the sixth section, challenges and problems given by the globalization process are briefly discussed. The seventh section concludes the paper.

## **2. Major Tenets of the Islamic Economics**

Islamic economics is presented as a superior alternative to existing economic doctrines and systems. It proposes a certain set of moral and institutional reforms based on the

traditional sources of Islam and these reforms are designed to overhaul the existing economic systems.

The prevailing economic systems neglect the moral dimension of human existence and feature aggressive opportunism, dishonesty, and mistrust. For example, corruption and cheating remain terrible problems of our economic lives. They altogether form a vicious circle and can not be eliminated completely. The main reason of this vicious circle is the selfishness inspired by Western individualism. Capitalist systems seek social efficiency through actions motivated by self-interest, and because of this they are occupied by unemployment, pollution, and uncontrolled poverty; and regulations to correct the shortcomings of capitalism are usually ineffective because those who implement them are governed by the wrong values (Kuran, 1997: p.26). However, Islamic economics insists that in a society whose members are endowed with Islamic values, the flaws of capitalism will be absent. Islamic economics emphasizes the encouragement of communal, non-individualistic values and fighting against selfishness. This is one of the distinguishing aspects of Islamic economics for it views communal values as critical to an economic system's operation.

Economics as that part of man's activity, which deals with the production of goods, accumulation of wealth, labor, work, trade, and exchange of goods and services etc., has been important in every civilization. Economics was never considered as a separate discipline or a distinct domain of activity in Muslim societies like their Western counterparts (Taheri, 2000). Consequently, there is no even a word for economics in classical Arabic. The term *Iqtisad* (economic) is used as a fair translation of the modern term "economics" in Arabic. *Iqtisad* has a very different meaning in classical Arabic. *Ihya-u-Ulum-id-Din*, a famous book written by Imam Gazzali defines the term primarily as a principle of moderation (i.e., golden mean) where it means "neither too much nor too little" (Taheri, 2000, quoted from Gazzali, 1971: p.265).

Early contributions to Islamic economics mostly came from Pakistanis, after the initial writings of Maududi, a famous Islamic activist. By 1975, about 75 percent of the contributions to Islamic economics are by Pakistanis. The share of non-Pakistani contributors has grown since then, but that of South Asians continues to dominate (Kuran, 1997: p.29). As Timur Kuran recognizes Pakistan is the only state founded with the special purpose of giving Muslims a place where they can govern themselves according to Islamic rules. Iran follows Pakistan in putting Islamic economics into practice. Therefore, it is reasonable to accept that these two countries made substantial contributions to Islamic economics.

According to Mohammed B. Sadr, three basic principles of Islamic economy are multi-faceted ownership, economic freedom within a certain limit, and social justice (Es-Sadr, 1980: pp.291-303). These are the three basic components of Islamic economic doctrine, according to which its theoretical content is defined. Islamic economics can also be distinguished from other economic regimes in terms of the broad lines given by these components.

### **2.1. The principle of multi-faceted ownership**

Islamic economic doctrine acknowledges different forms of ownership at the same time. Ownership is accepted in a variety of forms instead of only one kind of ownership such as private ownership, public ownership, and state ownership. So, it adopts the principle of multi-faceted ownership. Islamic economic doctrine essentially differs from capitalist and socialist regimes with this respect. It allows private ownership for a number of kinds of property and means of production. Similarly, it allows public ownership and state ownership for some kinds of wealth and property. But in its view neither the private ownership nor the public ownership is the basic rule. For this reason, it is very difficult to call it as capitalist economy or a socialist economy. Individual ownership, state ownership, and public ownership are three parallel forms in Islamic law (Shari' ah).

The Holy Book Qur'an makes clear that everything in the universe belongs to God and He is the real owner of everything: "Whatever in the heavens and whatever is in the earth belongs to Allah" [Al-Baqarah, 2: 284]. "And Allah is in the kingdom of heavens and the earth, and Allah has power over everything" [Al-Imran, 3: 189]. Real ownership belongs to God and man holds property in trust for which he is accountable to him, in accordance with the rules clearly defined by the Shari' ah. Therefore, absolute ownership of man is an alien concept in Islam, as it belongs to God alone.

Accordingly, the acquisition of property as well as its use and disposal are subject to limits set and principles guided by the norms of Islamic teaching. There are definite obligations towards others attending upon the individual ownership rights. The respective scopes of the three kinds of ownership are not strictly defined but left to be determined in the light of certain principles, depending on the needs and circumstances.

### **2.2. The principle of economic freedom within a defined limit**

The second basic component of the Islamic economy is to allow individuals, at the economic level, a certain freedom, within the limits of the spiritual and moral values of Islam.

The implementation of this principle in Islam is performed as follows: (a) Islamic law provides the textual stipulation to forbid a group of social and economic activities such as usury, monopoly, and so on. Because they hinder the realization of the ideals and values adopted by Islam. (b) Islamic law in principle lays down the supervision of the ruler over general activities and the intervention of the state to protect and safeguard public interest through the limitation of freedom of individuals in their actions.

*Self-interest:* According to Islamic view, the success of both the individual and the society depend on a balance between the spiritual and material needs of man. As we have mentioned, man is neither the absolute owner nor the total possessor of the earth and its resources. He does not have the right to possess as much as he desires or to obtain wealth in anyway he likes. Because he is the vicegerent of God and this vicegerency belongs to all people, each individual is a guardian of the public trust. In addition, his ownership should be limited for public welfare. It must not be forgotten that human progress depends on the successful coordination of and the essential harmony existing between the spiritual and material aspects of life. When the spiritual life is separated from the economic struggle of man, the required balance will be deteriorated. Therefore, the maintenance of such a constructive balance is very crucial to economic stability as well.

*Rationality:* Western sociologists define rational action as delimiting characteristics in terms of the ways adopted to reach the ends are specified. In this regard, values or emotions are not considered as rational. According to Islamic thought, the life of a Muslim in this world is a temporary phase in his permanent life the Hereafter. His success in the Hereafter is dependent on the utilization of the resources of this world in the best and right way. So, we see a big contrast between the Western thought and Islamic thought with respect to the meaning of *rationality* concept. But we should also note that while seeking the abode of the Hereafter, man could not neglect his share of the world. A right balance between the material and spiritual needs is necessary to accomplish this end.

*Free market:* Markets played an important role as distinctive places for transactions in Islamic economic history. Markets are regulated by price mechanism. With respect to the Islamic principles, the forces of supply and demand to bring the market in equilibrium have been well recognized. People are left free to transact and exchange goods and services. The state authority can only intervene if a transgression is illegally committed against one party. Shari' ah calls for fair and free trading, fully complying with principles. Besides, price controls merely with the aims of justifying this freedom and fighting corruption are

reasonably accepted. Islam has recognized the market system because of the freedom it offers to individuals. However, this system is not considered to be inviolable and unchangeable. The goals of the Muslim society are more important and the hoarding and profiteering of people's urgent needs for particular commodities, especially for imperative ones are absolutely prohibited.

### **2.3. The principle of social justice**

The third basic component of Islamic economy is social justice. It is the most prominent one among the others. Social justice is embodied in Islam by the elements and guarantees, which Islam provided for the system of distribution of wealth in the society. The Islamic image of social justice contains two general principles, each of which has its own lines and peculiarities. One is the principle of general mutual responsibility and the other is the principle of social balance. Islam permits divergence in wealth within a reasonable limit but does not tolerate this divergence growing so wide that some people spend their life in luxury and comfort, whereas the great majority of people are left to lead to a life of misery, hunger, and subsistence. Three elements necessary for the execution of social justice are *tawhid*, *Ijtihad*, and *ethics*.

*Tawhid* (monotheism) defines man-God relationship. The key social justice of Islamic economy lies in man's relationship with God, his universe, and his people, and the nature and the purpose of man's life on the earth. If a man believes in God and the day of judgement, he is completely aware of his duties and responsibilities to God and his creatures.

The second element after *tawhid* for the execution of social justice is *ijtihad*. *Ijtihad* means independent legal judgement, effort, or ability to deduce rules from sources. It is true that principles given by the Prophet were appropriate for a particular age, under particular conditions, and were applied to a particular society under entirely different conditions from today. Nowadays, Muslim societies are facing various political, economical, and social problems that can only be solved through *ijtihad*, particularly issues for which, there are no clear injunction in Qur'an or Hadith (i.e., Prophet's actions or sayings).

The third element for the enforcement of social justice in Islamic economy is *ethics*. With respect to the relationship between *ethics* and economics, there is also a big difference between the Western thought and Islamic thought. In the West, those who tried to connect economics with *ethics* considered it in a purely humanistic vein created by man. In contrast, economics is related to *ethics* and *ethics* in turn is related to religion in Islamic view.

Social justice can only be achieved through the establishment of two institutional reforms namely the zakat and the prohibition of interest. Zakat is a redistribution system that was present in Arabia fourteen centuries ago. The argument in favor of the revival and strengthening of zakat system is that it will provide a more effective safety net than the existing secular redistribution systems (Kuran, 1997: p.28). The other institutional reform aims at overhauling the entire financial system through the replacement of conventional banks by Islamic banks. The proponents of Islamic banking claim that such a system helps to solve major problems of underdevelopment (i.e., low growth and misdistribution) (Kuran, 1997: p.27). Because Islamic banking makes saving more attractive by giving savers opportunities to share in the profits of investors and because it transfer funds to entrepreneurs who have no chance to access financial markets and institutions before. And state plays a key role in the transformation process by creating a favorable environment to implement Islamic laws in the society.

### 2.3.1. Zakat

Zakat is a religious tax and an act of worship to please the God Almighty. Zakat is levied on the wealth, and not income, of every Muslim and Islamic institution. The importance of zakat can be best understood by the fact that it has been included among the five building blocks of Islam, and come just after pray. Therefore, it is obligatory and considered being a debt payable to God. According to Rakiya Ibrahim (2000), the idea behind zakat “is to purify wealth and enhance its redistribution within the society and to prevent its hoarding.” Certain categories of people are eligible to receive zakat (e.g. the poor, the needy, debtors, new converts, slaves, wayfarers, zakat officials and those that fight in the cause of God).

The obligatory duty to pay zakat is emphasized in various verses of the Holy Book Qur’an (see Al-Baqarah [2:43, 83,110], Al-Maide [5:55], At-Tavba [9:71], and so on). However, the types of assets that are subject to zakat are not specified. We know that the properties in the early days of Islam on which zakat are applicable, are not same as today’s properties. Besides, there are different opinions about the properties, which are applicable for zakat among jurists. In this regard, we think that the strongest view is that of Mohammed B. Sadr’s who says “instances of zakat and *Nisb* [exemption limit] and their amount in each period are determined by *ijitihad* with regard to the condition of time and place” (Taheri, 2000, quoted from Sadr, 1994: p.237).

According to the proponents of Islamic economic system, within the other economic systems, no such obligations are imposed on individuals or institutions for payments to be made to reduce the sufferings of those in need.

### 2.3.2. *Prohibition of interest or Riba*

One of the distinguishing characteristics of Islamic economic system is the prohibition of interest. The Holy Book Qur'an uses the word *Riba* for interest and *Riba* is sometimes defined as excessive interest where it means usury. Islam has categorically prohibited the giving or receiving of interest in any form. The Qur'an categorically declares any surplus or excess over the principal amount to be *Riba* and the prohibition of *Riba* applies irrespective of the purpose for which the loans have been raised. In many verses of the Holy Book this prohibition is repeated. For example, "O you who believe! Fear God and give up what remains of your demand for usury, if you are indeed believers" [Al-Baqarah 2:278]. Moreover, in one of the Hadith the Prophet condemns the person who gives, receives, bears witness or records any transaction that involves *Riba*.

Muslim scholars have accepted the word *Riba* to mean any fixed or guaranteed interest payment on cash advances or on deposits. As Ibrahim (2000) quoted from the Islamic Law Academy's declaration, "any increase or profit on a loan which has matured in return for an extension of the maturity date, in the case where the borrower is unable to pay, and any increase or profit on the loan at the inception [beginning] of the loan agreement" are both regarded as the forms of usury or *Riba* which is forbidden under Islamic law.

Ibrahim (2000) also briefly discusses some of the reasons why interest or *Riba* is against the Islamic spirit of justice and equity. Here they are:

- It discourages innovation by small businesses.
- It leads to bankruptcy and results in loss of productive potential for the society as a whole and causes unemployment.
- The debt burden makes it difficult for a depressed economy to recover, bringing additional suffering to the whole society.
- Banks working in this system has no incentive to participate a venture. That is, they have no interest in the venture except in so far as there are possibilities of recovering their capital and earning interest, any investment plan put to them is evaluated on the basis of this criterion.

She cited many examples on how socially injurious the interest-based system is especially for the Third World countries.

-The Third World is perpetually in debt as they are not capable of repaying international loans due to very high interest rates.

-Conditions attached to the loans (terms of loan contracts) is not flexible.

-Locally, customers who default in their loans or mortgages are at risk of losing their homes that they use as collateral.

-Due to high interest rates, local businessmen are reluctant or even unable to access banks for loans, and hence productivity and growth within the business sector is retarded.

According to the proponents of an Islamic economic system, because of all these reasons Islam forbids *Riba* in very strict terms. But it encourages investment with the expectation that people will invest their capital in a productive manner, and thereby increases their profits.

### **3. Money and Finance in the Islamic Economics**

In Islamic economics, money is only a medium of exchange and a way of defining the value of a good or service. It has no intrinsic value. That is to say, it has no store of value function in contrast to the traditional monetary analysis. Honesty and justice in all measures of value have been absolutely stressed in the Qur'an: "And give full measure and weight with justice" [Al-An'am 6:152]. This principle should not only be applied to the conventional weights and measures but should also be applied to all measures of value including money. In this regard, the only proper use of money arises from its purchasing power. So, the government should take the necessary steps to maintain the stability of the real value of money or its purchasing power.

However, this purchasing power cannot be used to make more purchasing power without going into the intermediate step of it being used for the purchase of goods and services. That is, money should not be allowed to give rise to more money via fixed interest payments. The human effort, initiative, and risk involved in a productive venture are more important than the money used to finance it. Money is a potential capital rather than a capital in the financial meaning. It becomes capital when it is invested in a business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not its

capital, as such; it is not entitled to any return. Muslims are encouraged to purchase goods and services and invest in business ventures but are discouraged from keeping money idle. Therefore, hoarding money is regarded as unacceptable.

In any economy, private investment takes place in two different ways: active investment, where one or more people put their own capital into a project, manage it themselves and enjoy the benefits of their labor and capital themselves; and passive investment, where the investor provides the capital and receives a return but takes no other part in the project. Broadly speaking, a passive investor has three options: one, deposit in a bank and receive interest; two, buy securities or bonds and receive interest; three, buy shares in a company and receive a dividend. As far as the basic principles of Islamic economy are concerned, the first two options will be regarded as *Riba* (interest) income and therefore prohibited while the last option and the active investment are permissible. On the entrepreneur side, an entrepreneur may finance his project by using his own funds (internal funds), by issuing stocks for his enterprise, or by borrowing on interest. In an Islamic economy, first two ways are permissible but the last one is not (A. L. M. Abdul Gafoor, 2001).

Both conventional and Islamic systems permit and encourage active investment, which rewards labor and capital from realized profits. They both also permit and encourage passive investment in shareholder companies, which too reward capital from realized profits in the form of dividends. But they differ in the other options of the passive investment. Because any investment that brings in *Riba* income or financing that involves the payment of *Riba* is prohibited in an Islamic economic system. So, the need to finance is same in both of the systems. However, options available to Muslim investors and entrepreneurs are different. In other words, there arise some difficulties on the side of Muslim investors who cannot or will not buy shares in a company and Muslim entrepreneurs, who do not have adequate internal funds or cannot raise capital through equity markets. This category of investors and entrepreneurs form a large section of the investor-entrepreneur community today in the world. Therefore, it is necessary for us to explore the options available to this group in the context of an Islamic framework.

### **3.1. Basic principles of Islamic finance**

Nida'ul Islam magazine (November-December 1995) specifies four basic rules of Islamic finance as follows:

### 3.1.1. *Qard al Hasana*

Islam allows only one kind of loan and that is *Qard al Hasana*. It literally means a beautiful loan whereby the lender does not charge any interest or additional amount over the money lent. *Qard al Hasana* was the primary source of financing introduced by the Prophet after entering Medina and is the only form of financing transaction praised in the Qur'an (See also Ibrahim, 2000). It was encouraged by the Prophet for channeling savings into investment and productive activities; it was used also to create employment, reduce poverty and increase productivity. The first principle of Islamic finance emerging from *Qard al Hasana* is that any predetermined payment over and above the actual amount of principal is prohibited. Traditional jurists have interpreted this principle so strictly that, according to one commentator "this prohibition applies to any advantage or benefits that the lender might secure out of the *Qard* [loan] such as riding the borrower's mule, eating at his table, or even taking advantage of the shade of his wall." *Qard al Hasana* is a non-interest-bearing loan and there is no tangible benefits accrue to the lender. It is repaid as and when the borrower is able. Today, Islamic banks often provide it for education or medical care. They are only allowed to charge an operational fee for this service.

### 3.1.2. *Participatory financing*

Under this principle, the lender must share in the profits or losses arising out of the enterprise for which the money was lent. Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business venture, whether they are industries, banks, farms, service companies or simple trade deals. There is no room for hoarding money or depositing money in a bank in return for receiving an interest on these funds without any risk. Islam encourages the notion of higher risks and higher returns and promotes it by leaving no other way available to investors. The objective is that the risky investments provide a stimulus to the economy and encourage entrepreneurs to maximize their efforts.

### 3.1.3. *Prohibition of Gharar*

Under this rule, any financial transaction entered into should be free from uncertainty, risk, and speculation. Contracting parties should have perfect knowledge and insight of the counter values intended to be exchanged. Parties cannot predetermine a guaranteed profit either. *Gharar* is also called as the principle of "uncertain gains." On a strict interpretation, it

does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to compensate inflation. The rationale behind *Gharar* is to protect weak from exploitation. Accordingly, futures and options contracts and forward foreign exchange transactions are regarded as non-Islamic, so is the indexation of indebtedness to inflation. However, a number of transactions are considered as exceptions to the *Gharar* principle. For example, sales with advanced payment (*bai' bithaman ajil*), contract to manufacture (*Istisna*), and hire contract (*Ijara*). There are legal requirements for the conclusion of these contracts to be organized in a way to minimize risk.

#### *3.1.4. Prohibition of unlawful activities*

Investments should only support practices and products that are not forbidden-or are even discouraged-by Islam. Trade in alcohol, pork products, night club activities, pornography and so on would not be financed by an Islamic bank; a real estate loan could not be made for the construction of a casino; and the bank could not lend money to other banks at interest (i.e., interbank operations).

### **3.2. Islamic banking versus conventional banking**

In modern times, the need arises for a financial intermediary who could bring the investor/financier and the entrepreneur/borrower together. Conventional banks perform this function of channeling funds between the two parties very effectively and efficiently. Capital holders deposit their funds with the bank, and entrepreneurs submit their project proposals to the bank, the bank examines the business plan and if it is satisfied that the project could bring in sufficient income to allow the repayment of the principal and interest, and provided sufficient collateral is also available, the bank advances a loan. The bank does not get involved with the project; whether the entrepreneur/borrower makes a profit or loss he pays the principal and interest on due dates, or the bank has recourse to the collateral. The bank accepts of the depositor's capital, guarantees its full return, and pays him an interest (or return on his 'investment') at a fixed rate, and uses the capital to grant loans to borrowers. But the interest rate given to the depositor is always smaller than the rate the bank charges to the borrower, and the difference goes to cover its own expenses and profits.

According to A. L. M. Abdul Gafoor (2001), this indirect mode of finance (depositor-bank-customer relationship) seems to work very well if people have no qualms about paying or receiving interest, despite the built-in injustice to both the entrepreneurs and the depositors. But some people are beginning to have qualms, and Muslims are prohibited from earning an

income in this manner. Therefore, this is also the point where Islamic banking emerges as a response to Muslims' demand for an alternative method to address their needs, minus the injustice.

Generally speaking, all Islamic banks agree on the basic principles of Islamic finance discussed above. However, individual banks differ in their application. According to A. L. M. Abdul Gafoor (1995), these differences are due to several factors including legal structure of the country, objectives of different banks, individual bank's circumstances and experiences, the need to interact with other interest-based banks, etc.

It should have been clear by now that the main difference between the conventional banking system and the Islamic banking system is that properly Islamic banks avoid interest. If you borrow funds from an Islamic bank to finance a business venture, the bank cannot, as a conventional bank might, charge you interest on the loan (Kuran, 1997: p.27). It can accept a share of your potential profits, along with a share of your losses in the event your project is failed. Conventional banking on the other hand is interest and credit based, it relies on the ability of the borrower to repay the principal together with the interest. It is based on deposit taking and making profit by charging different interest rates to depositors and borrowers.

The *first* distinguishing aspect of Islamic banks is that they are required to operate under strict religious guidelines and ensure that their transactions and products offered to the public are in strict conformity with Islamic laws and principles. By their very nature, these are divine injunctions and cannot be removed by any authority. On the other hand, conventional banks whose roots are in the capitalist economic system are driven by profit motive. Under this system, the first priority is given to the private ownership and unchecked powers in economic decision-making are the rule. So, here the restrictions are man made such as those that are contrary to public policy or banking regulations.

Fundamentally, there are three main parties in financial transactions today: the owners of capital, the entrepreneurs who require financing and bankers who act as agents between the two. Islamic banks are therefore seen as fulfilling the role of an intermediary which brings together the suppliers of funds and those who need them and the Islamic bank is a partner to both. But this is a different form of *participation* which does not separate risk and return. The depositor, the bank, and the borrower should all share risks and rewards of the financial transaction. This is not the case in the interest based commercial banking system, where all the pressure is on the borrower: He must pay back his loan, with the agreed interest,

regardless of the success or failure of his venture. To protect itself, the bank relies on security or collateral.

Modern commercial banking is based on a creditor-debtor relationship between the bank as a lender and the customer as a borrower. This debtor-creditor relationship in commercial banking is viewed as an unfair one from Islamic perspective because it gives more leverage to the creditor (bank) compared to the debtor (customer). It focuses on the principle of employing funds on a time/cost basis and charging interest. On the other hand, Islamic banking is based on *the principle of sharing profits and losses* between the borrower and the lender. Islamic bank acts as a partner in sharing the risks of the business. This is completely legitimate in Islam because the bank may make a loss and is not getting a fixed return. Similarly, the customer benefits too because he can feel sure that he would not have to pay a fixed amount irrespective of the outcome of the business. Likewise, depositors also take a share in the risk as well as the profit. Therefore, all parties benefit and this fulfil the criteria of equity and justice, which Islam insists on.

According to Ibrahim (2000), Islamic banking system is beneficial to a society for two more reasons: (a) Profit and loss sharing is more likely to guarantee the utilization of resources in enterprises, which are of genuine use to society. Because under this system banks will not lend money only to large and well-established companies, but will also lend money to small enterprises who have good investment projects which would help society and in which they can confidently share. (b) Such a system may foster technological development because the bank seeing the possibilities of innovations in terms of profit would go into partnerships to provide funds for those innovations which it judges would be fruitful.

Another feature of Islamic banking, which makes it different from conventional banking, is in relation to *defaulters*. Islam makes a distinction between two categories of defaulting debtors. One type is he who defaults by necessity (i.e., a person whose financial situation is such that with the best of intentions he simply lacks the means of payment). The Qur'an is explicit on this type of borrower and states that the debtor deserves compassion and to be given a grace period. It is required that the defaulter be given a rescue until he is able to pay. The Holy Qur'an expressly states: "And if the debtor is in difficulty, grant a delay until a time of ease. But if you remit it [the debt] by way of charity, that is best for you if you only knew" [Al- Baqarah, 2:280]. This verse suggests that creditors should readily grant pressed debtors additional time to pay. Islam does not encourage a creditor to give an extension to every debtor who defaults. The extension is for debtors in genuinely financial distress.

As for the second type, the debtor who refuses to pay even though he has the means, he is a perpetrator of injustice (zulm) who, far from deserving alms, exposes himself to possible punishment. The Prophet condemns the person who delays the payment of his dues without a valid excuse. He said in a Hadith “The well off person who delays the payment of his debt subjects himself to punishment and disgrace.” The fulfillment of one's obligation under all contracts is a religious duty for every Muslim. God says: “O you who believe! Fulfil (all) your undertakings” [Al-Maide, 5:1]. And He says: “...and keep the covenant. Lo! Of the covenant it will be asked” [Al-Isra, 17:34]. Whereas in conventional banking as soon as the loan matures or reaches its maturity dates, interest starts to accrue irrespective of the financial situation of the debtor.

Unlike the conventional bank, the Islamic bank has to take extra measures to protect itself from defaulting clients. The responsibility is higher on an Islamic bank to establish the character of the borrower by obtaining a character reference, possibly a credit history of the client. The primary assumption is that this situation should not arise as every true Muslim should pay his debts when due as a religious obligation.

Another distinct feature of an Islamic bank is the role of the *Shari' ah supervisory board* (SSB), which forms an integral part of an Islamic bank. Almost every Islamic bank has a committee of religious advisors whose opinions are sought on the acceptability of new instruments and who have to provide a religious audit of the bank's end of year accounts. SSB is defined as an independent body of specialist jurists in Islamic commercial jurisprudence. However, the SSB may include a member other than those specialized in Islamic commercial jurisprudence, but who should also be an expert in the field of Islamic institutions and with knowledge of Islamic commercial jurisprudence. The SSB is entrusted with the duty of directing, reviewing, and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic law and principles. The decisions and rulings of the SSB shall be binding on the Islamic financial Institution.

The ability of the SSB to contribute to the success of the bank is dependent upon the board's ability both to monitor the bank's conformity to the Shari' ah and to provide the necessary expertise to create new forms of banking transactions. By this way, SSB will help and enable the bank to participate in the modern financial world. So, the first function of the SSB is to review the operations of the Islamic bank for compliance. Secondly, SSB acts as an innovator in the sense that in a very complex and technically sophisticated world of finance, SSB scholars must be familiar with modern financial techniques and products in order to

determine their compliance. With the constant development of Islamic finance, the involvement of Shari' ah scholars are essential.

Although an Islamic bank differs from a conventional bank in the principles on which it operates, its main objective, like that of a conventional bank, is to provide good returns to its depositors and distribute reasonable dividends to its shareholders. It has to be run like a financial institution, that is managing the funds of others with the additional responsibility of investing them only in Shari' ah compliant transactions and without interest. In essence, both systems utilize resources to promote trade and development in a global environment.

*Secondly*, the focus of Islamic banks on making investments may differ from that of conventional banks, but this does not mean that Islamic banks are unaware of their obligations as financial institutions, or that they invest funds indiscriminately. On the contrary, being trustees of the Muslims' funds, they have to be even more careful in how they distribute them. Their standards of capital adequacy, liquidity ratio, distribution of risks are at least as high as, if not higher than that those of the conventional banks.

*Thirdly*, there are several activities of the Islamic banks, which are similar to those of conventional banks. Islamic banks world-wide offer a full spectrum of fee-based financial services that do not involve interest payments, including checking accounts, spot foreign exchange transactions, fund transfers, letters of credit, remittances, travelers' cheques, safe deposits, custody, and other normal services of modern banking. Another similarity is on leasing. Islamic leasing (Ijara) and lease purchase (Ijara WA Iktina) are offered and is widely accepted as financial instruments. Islamic mortgages are also offered.

*Fourthly*, a similarity exists between the two systems in relation to the enforcement of debt contracts. Just like the conventional system, a contract entered into between the Islamic financial institution and its client is legal and valid and in the event of default the Islamic financial institution can exercise its right in court to enforce the contract based on a creditor and debtor relationship. Some Islamic jurists argue that which is compulsory in religion is enforceable in law, too. Also, there is a majority view that anything prohibited in the Shari' ah if committed can be punished under what is called *ta'zeer*, where the punishment is not specified. With respect to the penalty to be imposed on the defaulter, the judge exercises his discretion depending on the nature of default. He can warn, threaten, disgrace or even imprison the defaulter and if necessary dispose of his assets to pay the debt. However, it is generally agreed by Islamic jurists that a monetary fine is not one of the options open to the

judge in this case as this would amount to a monetary penalty for deferred payment, which is *Riba*.

### **3.3. Islamic financial instruments**

Islamic financial transactions today are made in so far as they are not inconsistent with the injunctions of the Islamic law or contradict those approved by the Prophet. During his period, the traditional Islamic financial instruments derived their legitimacy and validity under Islamic law from the fact that either the Prophet himself adopted them or they were in practice in his time and he either expressed his approval of them or did not prohibit or make any changes in them. For example, the preferred Islamic investment tools of *mudaraba* and *musharaka* have been specifically approved.

Islamic banks around the world have devised many creative financial products based on the risk sharing, profit sharing principles of Islamic banking explained above. From day to day, a number of financial instruments have been developed that satisfy the Islamic economic doctrine and provide legitimate financial returns for Muslim investors. Broadly speaking, Islamic banks are actively engaged in commodity trade finance and property leasing. Some of the basic financial instruments of Islamic banking are given below (Nida'ul Islam, 1995).

#### *3.3.1. Mudaraba*

The Islamic mode of financing, *mudaraba*, where the capital owner, the Islamic bank in this case, provides the capital and the other party provides skill, labor and management. Under the agreement the bank is not involved in the day to day running of the business but is free to stipulate certain conditions that it may deem necessary in order to ensure the best use of its funds. After the expiration date of the contract, which may be the termination of the contract or such time that returns are obtained from the trade, the bank gets back its principal plus share of the profit. In the event of loss, the bank will bear all the loss and the principal will be reduced by the amount of the loss. Due to the possibility of loss occurring, the bank is entitled to a share in the profit of the business.

#### *3.3.2. Musharaka*

*Musharaka* is also a partnership. The parties share in the management of the project and share profits and losses in relation to their financial contributions. This is a partnership, normally of limited duration, formed to carry out a specific project. It is therefore similar to a western style joint venture. *Musharaka* is also regarded by some jurists and Islamic economists as the purest form of Islamic financial instrument, since it conforms to the

underlying partnership principles of sharing in, and benefiting from, risk. Participation in a *musharaka* can either be in a new project, or by providing additional funds for an existing one. Profits are divided on a pre-determined basis, and any losses occurring shared in proportion to the capital contribution. Translated into banking terms, under *musharaka* agreement the bank enters into a partnership with a client in which both share the equity capital -and perhaps even the management- of a project or deal, and both share in the profits or losses according to their equity shareholding.

### 3.3.3. *Ijara WA Iktina*

It is equivalent to the leasing and installment-loan, hire purchase, practices that put millions of drivers on the road each year. These techniques as applied by Islamic banks include the requirement that the leased items be used productively and in ways permitted by Islamic law.

### 3.3.4. *Muqaradah*

This technique allows a bank to float what are effectively Islamic bonds to finance a specific project. Investors who buy *muqaradah* bonds take not only a share of the profits of the project being financed, but also a share of the risk of unexpectedly low profits, or even losses. They have no rights in the management of the project, but they act as non-voting shareholders.

### 3.3.5. *Salam*

Here, a buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed price. This financing technique, similar to a futures or forward purchase contract, is particularly applicable to seasonal agricultural purchases, but it can also be used to buy other goods in cases where the seller needs working capital before he can deliver.

## 4. Factors Motivating the Development of Islamic Economy and Finance

Institutional, moral (behavioral), ideological, political, and cultural factors motivated the development of Islamic economy and finance in the world. As for the institutional dimension, Kuran talks about the opening of Islamic banks, the prohibition of every form of interest, and the establishment of official redistribution systems in some Muslim countries (Kuran, 1995: p.155). He also mentions the increasing importance of Islamic enterprises such as retailers, publishers, investment companies, factories, construction firms, and even

conglomerates in these countries. According to him, “these enterprises, along with the Islamic banks and redistribution systems, have formed vibrant sub-economics” especially in the Islamic metropolitans of the world.

The moral dimension of this story comes from the demand by Muslims for Shari’ ah compliant financial products and services. Their beliefs prevent them from dealings that involve usury (excessive or illegal interest) or interest. Muslims need financial services as much as anybody else and for similar purposes: to finance a business venture, to buy a house or a car, to make capital investment, to facilitate trade, and to offer a safe place for savings (Nida’ul Islam, 1995). Muslims are not averse to legitimate profit as Islam encourages people to use money in legitimate activities and does not order them to keep their funds idle. Because of these reasons, Islamic financial instruments may be of interest to both Muslims and non-Muslims. People recognize the justice and benefits in the Islamic financial system. Trevor Gambling acknowledges the fact that “there is a commercially significant growth in demand for ‘ethical investment’ both inside and outside Islam” (Ibrahim, 2000). Therefore, moral dimension of this story explains in part why Muslims find room for the principles of their religion today: a global network of Islamic banks, investment houses, and other financial institutions with a multi-billion dollar deposits.

There exist two conflicting views on the ideological, political, and cultural dimensions of the question. According to the first view, Islam is not only a religion but also a complete way of life, as such all of man’s activities (social, political, economic etc.) are subject to and governed by Shari’ ah. The basic sources of Shari’ ah are the Qur’an and the Hadith of the Prophet. The basic concept of wealth in Islam is that man is created as a vicegerent of God in this world. He should exercise the delegated power of the God by holding all his wealth in trust and thus is required to keep to a certain set of values in dealing with it. As a trustee man has an obligation to optimize his use of the world’s resources for the general good of the society. Social justice and communal values are important here.

According to the second view, Islam is a religion that emerged 14 centuries ago. So, its orders, its rules, and its principles are not appropriate for modern life. Islamic economics is incoherent, incomplete, and impractical. It is not capable of raising productivity, stimulating growth, or reducing inequality. Because the main purpose of Islamic economics is not to improve economic performance. Although it promised to provide a superior alternative to other economic doctrines, its real purpose is to help prevent Muslims from assimilating into the emerging global culture whose core has a Western pedigree (Kuran, 1997: pp. 26, 29, 32).

The essential function of Islamic economics is to develop a sense of Muslim cultural separateness and to protect Muslim cultures. Kuran supports this view by referring to the speeches and writings of Sayyid Abul A'la Maududi. According to Maududi, Western secularism was about the lock Islam in the mosque. Even worse, secularism was turning Muslims into pseudo-Muslims with mindsets and lifestyles indistinguishable from those of Westerners. From Maududi onwards, Islamists have taken every opportunity to promote stronger social and economic ties among Muslim communities, hoping that these will pave the way for an Islamic common market and, ultimately a pan-Islamic state.

However, this second view does not deny or undermine the positive aspects of Islamic economics and the merits of Islamic value system. As Kuran argues “its applications, though generally not harmful and sometimes beneficial from a narrowly economic standpoint, have not brought major changes to economic life” (Kuran, 1997: p.28). We should not forget the Islam’s contributions to global economic evolution. Barter rules, the rights of slaves, the permission to sell fruit trees in bloom, rules concerning other transactions, and investment practices that had an influence on the development of contract law in Europe are some examples of such contributions. They were all originated from Islamic values and were all shaped by Islamic institutions. But it is quite different to see them as solutions to today’s social, political, and economical problems.

### **5. Islamic Economy and Finance in Practice**

As a school of thought, Islamic economics emerged in 1940s and it essentially remained an intellectual debate for many years. However, beginning from 1970s onwards, various countries of the world, whether they are Muslim or non-Muslim ones have taken some initiatives to give their economies an Islamic aspect. For example, a few of them have instituted religious redistribution systems known as zakat, more than sixty countries have established Islamic banks as an alternative to conventional banking regimes, and still some others went one step further by stating that every form of interest was forbidden.

The history of Islamic banking or interest-free banking can be divided into two eras. In the first era, from the mid-1940s until the end of 1960s, several authors wrote on the need to reorganize the existing commercial banking system on the basis of profit and loss sharing rather than interest. In the second era, early 1970s, Islamic banking became a reality with the efforts of Muslim countries’ governments and inter-governmental organizations. These efforts were resulted in the establishment of first interest-free bank, The Islamic Development Bank

in 1975, which was an inter-governmental bank. The first private Islamic bank, the Dubai Islamic Bank, was also founded by a group of Muslim businessmen from several countries. One important factor behind the establishment of first Islamic banks was the oil price increases of the 1970s. Oil price crises created a need to recirculate massive sums of Arab petrodollars and it is at this time that the institutional infrastructure of Islamic economics got a stimulus from the oil-rich Arab regimes (Kuran, 1997: p.29). In the ten years since the establishment of the first private commercial bank in Dubai, more than fifty interest-free banks have set up (A. L. M. Abdul Gafoor, 1995). Though nearly all of them are in Muslim countries, there are some in Western Europe as well. Many other Islamic banks were established in 1980s. But the numbers have declined in 1990s. In most of the countries interest-free banking had been established by private initiative but in Iran and Pakistan, it was by government initiative and covered all the banks in the country. In sum, over the last quarter of the twentieth century, Islamic banking re-emerged within the global financial system.

According to Ibrahim (2000), Islamic financial institutions are managing funds approximately US\$200 billion and have an annual growth rate of 10-12%. Recently, there is a growing interest by conventional banks in the Islamic financial system and this interest is reflected in recent mergers between Islamic banks and conventional banks in the Middle East. For example, in Russia there was a merger between Badr Islamic Bank and Forte Bank; Citibank has opened a completely Islamic bank in Bahrain; many conventional banks started to open "Islamic windows" offer Shari' ah compliant products to the public. In Bahrain and Malaysia, a global Islamic money market was launched in 2000. In Europe, many Islamic mutual funds have been established. In USA, Dow Jones formed an Islamic Index that tracks Shari' ah compliant stocks from other regions of the world. In 2000, The Islamic Development Bank and a private company from Malaysia signed an agreement to implement an information system network with the aim of improved flow, exchange, and dissemination of information among the OIC (Organization of Islamic Conferences) member countries. Central bank of Indonesia, Bank Indonesia, recently changed its procedures to allow Islamic banks to make interbank operations and make deposits with the central bank according to the Islamic rules. In Thailand, The Bank for Agriculture and Agricultural Cooperatives has set up Islamic banking activities in at least 30 of its branches and was planning to expand them by the end of 1999. Islamic banking is the fastest growing sector in the Middle East. An estimated US\$100 billion worth of funds are now managed according to the Shari' ah in this market.

In practice, we observe two developments concerning the implementation of Islamic redistribution system, zakat. On the one side, we see some countries like Pakistan and Malaysia, which established official zakat systems to collect funds and spend them on the poor. On the other side, we see some Muslim countries like Egypt and Saudi Arabia in which private companies, banks, and institutions established zakat funds. For example, Faisal Islamic Bank of Egypt distributed 67 million Egyptian pounds by way of zakat from its zakat fund in 2000 whose recipients were mainly the students and other needy individuals. Zakat is also collected in secular Muslim countries (e.g. Turkey) via the private foundations and associations especially during the month of Ramadan.

It is not surprising that quite a number of countries in the Islamic world have either eliminated or are in the process of elimination of interest from their financial systems. For example, Iran and Sudan economies are operating under the interest free system, and in December 1999, Pakistan's Supreme Court declared interest unlawful and Pakistan government has been given to the mid-2001 to get rid of interest from its financial system. In general, since the early 1980s, Muslim governments have followed three ways in operating their banking system (Nomani, 2003: pp. 37-8). The first group, which includes Iranian and Sudanese governments, claim that their banking system and banking law are completely Islamic. The second group, which includes Pakistan, Egypt and Saudi Arabia, adopt a dual banking system. They have avoided separate legal and regulatory frameworks and allowed Islamic banking to operate under existing laws for conventional banks. In the third group, there is only Malaysia, which has officially separate legal and regulatory systems for Islamic banks. She adopts a parallel banking system in a systematic and planned manner.

One more recent development about the growing interest in Islamic economics and finance which is coming from the academic side. Several articles, books, and doctoral theses have been written on Islamic banking and finance during the last quarter of the twentieth century. And many conferences have been held on to discuss the concepts and possibilities of Islamic banking, its evolution, its performance, and its impact on the rest of the economy or the world. This change in academic agenda is another reason for the increasing importance of Islamic economy and finance in the global world.

As for the Turkish experience, Islamic banking was first introduced by financial liberalization efforts under a special legislation with Arab investors in 1985. Their balance sheets, profit-loss statements, market share, and the number of branches and employees have fairly increased since the mid of 1990s (Jang, 2003: pp. 2, 14). As of June 2006, total assets of

four Islamic banks (i.e., Albaraka Türk, Bank Asya, Türkiye Finans, and Kuveyt Türk) had reached to a 12.3 million Turkish Liras (TLs), and their number of branches and employees were 310 and 6348 respectively (Günel, 2007: pp. 184-5). Recently, the Turkish Islamic banks were officially integrated into the commercial banking system largely owing to the financial reform programs of the IMF and the World Bank. Until 1999, a dual banking system existed. In 1999, with the act number 4389, they were included under the Banks Law. In 2001, with an amendment to the Banks Law, the Association of Special Finance Houses parallel to the Bankers' Association of Turkey and a common deposit insurance system were established. Moreover, Basel Committee capital adequacy requirements and supervisory standards were introduced. In 2005, the New Banking Act renamed and included them into the definition of a bank along with deposit banks and investment and development banks. The Savings Deposit Insurance Fund took place their common insurance system. Islamic banks, which were formerly called Special Finance Houses, are now called Participation Banks and the Association of Special Finance Houses became the Association of Participation Banks of Turkey.

As far as the ownership structure of Islamic banks was concerned, there are two main groups in Turkey. The first group consists of locally financed Islamic banks such as Asya Bank and Türkiye Finans, which began to be established since the early 1990s. The second group includes the Islamic banks established as joint ventures with Arab companies such as Albaraka Türk, Kuveyt Türk, and Faysal Finans, which emerged in the mid 1980s.

## **6. A Performance Evaluation**

Problems with the Islamic economics and finance arise in the application stage. Let's start with Islamic banking, the first institutional element of overhauling the existing economic systems. It is widely accepted that the Islamic banks are roughly as profitable as their conventional counterparts, and that they are making positive contributions to various economies (Kuran, 1997: p.27). But in no way have they revolutionized financial practices. 1990s have witnessed a marked decline in the establishment of new Islamic banks and the established banks seem to have failed to live up to the expectations (A. L. M. Abdul Gafoor, 1995). Even the leading advocates of Islamic banking now criticize their operations and talk about the necessary changes in their practices. According to this people, Islamic banking is a very new concept and despite its successful acceptance around the world, it has some problems and these problems are mainly in the area of financing. With only minor changes in their practices, Islamic banks can get rid of all their cumbersome, burdensome and sometimes

doubtful forms of financing and offer a clean and efficient interest-free banking. On the other side, there are some people who seriously criticize Islamic banking on three grounds. According to this group, (a) Islamic banks give and take interest as a matter of course, often through clever ruses designed to make interest look like profit, (b) Islamic banks are not channeling funds primarily to new entrepreneurs; in fact, most of them are very conservative in their lending practices, and (c) Islamic banks have introduced a few innovations, but these hardly form a radically new financial system (Kuran, 1997: pp.27-8)

There is a puzzling aspect of Islamic banking. The puzzle is that the banks have spread and grown even though their operations are based, for all practical purposes, on interest. One of the factors in this popularity is that the banks serve as an instrument of guilt reduction for depositors and borrowers who believe that, even if they are not actually interest-free, they are at least morally superior to conventional banking. According to Kuran, Islamic banks foster an image of moral superiority by making a point of contribution to Islamic causes and also through signs of Islamic devotion at their branch offices: prayer areas, Qur'anic verses on the walls, veiled female and bearded male staff, religious literature for the taking (Kuran, 1997: p.35). However, the proponents of Islamic banking are completely against this view. The problems of Islamic banking can be resolved within the same system because all the necessary ingredients are already there. The modified system will make use of only two forms of financing –loans with a service charge and *Mudaraba* based participatory financing –both of which are fully accepted by all Muslim authorities on this subject (A. L. M. Abdul Gafoor, 1995). According to them, such a system will (a) offer an effective banking system where Islamic banking is obligatory and a powerful alternative to conventional banking where both co-exist and (b) will have no problem in getting permission to operate in non-Muslim countries. Besides, participatory financing is a unique aspect of Islamic banking because it can offer responsible financing to socially and economically relevant development projects.

As far as the official zakat systems instituted in various countries are concerned, they have not lived up to expectations either. There is no evidence that the zakat systems in force combat poverty more effectively than non-Islamic relief systems (Kuran, 2002: p.21). In Pakistan, the official zakat system does not even meet the subsistence needs of the small minority of the poor that it assists. In Malaysia, zakat results in perverse redistribution, in that it collects funds primarily from poor peasants and spends them on often wealthier government workers living in cities. But now there are efforts to overcome this perversity through urban collections. According to Kuran, in both of these countries there have been reports, including

official ones, of serious irregularities in both collection and disbursement (Kuran, 1997: p.28). But it is also true that in non-Muslim societies irregularities encompass secular redistribution systems, too. So, income redistribution is not a problem peculiar to Muslim countries alone.

Although Islamic economics promises to do much better on these issues, which factors are playing an important role behind its weak performance around the world? Firstly, not all the Muslims in the world share the same lifestyles. There is no uniformity among them despite Islam's emphasis on religious brotherhood and hospitality. There are vast differences between the lifestyles of secularized Muslims in Turkey and devout Muslims in Kelantan, between life in a Bengali village and life in royal palaces of Saudi Arabia. But the proponents of Islamic economic system largely overlook such differences. Secondly, even though Islam is a religion of honesty, justice, and equity, contemporary Muslim communities are still suffering from rife with greed, corruption, dishonesty, deceit, and exploitation. These problems cannot be avoided simply through praises of Islamic virtue. In the absence of institutional reforms that make socially undesirable behaviors more costly and burdensome, these problems will not disappear. So, substantial improvements in legal systems, industrial standardization, and removal of antitrust regulations are necessary. Thirdly, Islamic economists disagree among themselves on many important matters, and their programs contain contradictions. For example, there are different interpretations on the issues of *Riba* and *Gharar* among the Sunni and Shi'i scholars (Nomani, 2003: p.37). Because the *Ijtihad* door was closed for several centuries ago and it fell behind the modern conditions of life.

Taking all these considerations into account, a Muslim today determined to abide by all Islamic injunctions will find it impossible to pursue a life that is properly Islamic beyond all doubt. Under modern conditions, it is impossible to live up to the moral ideals of Islam in general and Islamic economics in particular. Proponents of Islamic economics claim that the foundations of correct and just economy based on Islamic rules without establishing the Islamic state is impossible. We don't know today whether there exists a purely Islamic state or not but supporters of this ideal are mainly aiming at the preservation of Islamic identity and serving the anti-assimilationist goal of Islamism.

While evaluating the performance of Islamic finance in Turkey, first of all, we have to mention that it was a late development in the financial and economic history of the country. However, Islamic banks have steadily gained importance, improved their positions, and in absolute numbers outperformed conventional banks since the end of 1990s (Jang, 2003: p.14). The domestically owned Islamic banks have expanded their market shares, number of

branches, and number of employees more than Arab capital owned banks since the mid of 1990s.

If we look at the basic indicators of the banking sector in Turkey, the highly promising progress of the Islamic banks can be apparently seen. Their share in total assets of the banking sector was 1.87% in 1995 and it increased to 2.13% in 2000, and then declined to 1.08% in 2001, and had an upward trend since 2002, and finally reached to 2.44% at the end of 2005 (Günel, 2007: p.185). As of June 2006, total assets of Islamic banks was amounted to 12.3 million TLs, their sources and uses of funds were 9.9 million TLs and 9.1 million TLs respectively while their total equity capital was equal to 1.3 million TLs. As of June 2006, they made a total profit of 163 thousand TLs. However, their relative shares in the financial system of the country were remained at very low levels as compared to the conventional banks.

### **7. Challenges Ahead of Globalization**

Islamic finance has grown in size and significance in a large number of countries throughout the world. The introduction of broad macroeconomic and structural reforms, liberalization of capital movements, privatization, global integration of capital markets, and the introduction of new Islamic financial instruments have all played an important function in this rapid expansion process of the Islamic economy and finance (Zaher and Hassan, 2001: p.194). Islamic banking and finance have reached to a high level of sophistication. However, many problems and challenges relating to the healthy development of this system remained unsolved. Therefore, they must be addressed and examined carefully.

Here are some of them: (a) The lack of a uniform regulatory and legal framework that supports an Islamic financial system, (b) the need for risk analysis and risk management tools to hedge the high risks in currency and commodity markets, which are based on the interest system, (c) the strong need for an Islamic interbank market to satisfy the liquidity requirements of Islamic banks, (d) the need for sound accounting procedures and standards, which are compatible with Islamic laws, (e) the need for a more innovative and flexible approach to Islamic law, (f) the need for a good understanding of Islamic banking and finance on behalf of the ordinary people, (g) the need for mergers and cooperation among Islamic banks in global competition as their small sizes relative to the conventional ones are concerned, (h) the need for inclusion in the lender of last resort function of the central banks, (i) the need for more flexible and suitable capital requirements, and (j) the need for developed

secondary markets for Islamic products in terms of breadth and depth, and the existence of money markets (Zaher and Hassan, 2001: pp.187-90). As far as the Turkish experience is concerned, we should add the service quality and product diversity dimensions to the above problems along with the provision of high-tech infrastructure (Günel, 2007: p.185).

Unless these issues are resolved, Islamic banking and finance will lag behind the conventional banking system forever in a globally competitive environment and Muslim people whether they are borrowers or savers cannot benefit the opportunities provided by the financial system.

## **8. Conclusion**

Islam is the fastest growing religion in the world. Muslims now constitute approximately the 30 percent of the world population. Wherever they live, whether in Muslim countries, secular Muslim countries or non-Muslim countries, this people want to protect their identities, obey the rules of their religion, and try to escape from other nations' cultural influences and hegemonies. Inevitably their concerns are reflected in their economic lives. In the last quarter of the twentieth century, there has been a large-scale growth in Islamic finance around the world owing to the desire for sociopolitical and economic systems based on Islamic rules and a stronger Islamic identity. We think that the increasing demand for Islamic financial institutions and instruments is the outcome of this process.

We are living in a world of change and we entered into a new century. If we want to know how Islamic society will shape its own identity, we have to understand Islamic economy and finance deeply with all its principles, rules, and institutions. While doing so, we always have to keep in mind the following dichotomy. On the one side, there are some people who view Islam as a way of life and on the other side, there are some people who view it only as a religion. That's why Islamic economics is a multi-dimensional and controversial topic. Islam in its simplest and purest form is full of moral values and ideals. There is nothing contradictory to these values and ideals in its main sources. Moral values and ideals are also at the center of Islamic economics. Yet the Islamic economics could not go beyond to a less known radical school of economic thought. A complete Islamic economic and financial system is still far from existence. Because many problems and challenges accompanied the development of its institutions and instruments. Although it is promising and high yielding, Islamic finance and banking is at an early stage of development in the Turkish economy, as well.

In my opinion, an Islamic financial system can play a significant role in the economic development of both Muslim and non-Muslim countries by mobilizing idle funds that are put aside interest based financing methods and facilitating the development of capital markets. Furthermore, the development of such systems would enable Muslim borrowers and savers to choose financial products that are compatible with their needs, values, and beliefs. However, the realization of this process may take some time given the opportunities and challenges provided by the global economy.

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