Review
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BANKING WITHOUT INTEREST

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Abstract
In recent years, there has been increased global awareness of Islamic finance. This topic is mainly opened with respect to the great financial crisis that mostly hit the banking system and the financial markets and caused many bank bankruptcies and state interventions. This paper analyzes the basic principles of Islamic banking. The absolute prohibition of receiving and giving interest (Riba) and profit-and-loss sharing (PLS) paradigms are elaborated in detail; they are primarily based on mudarabah (profit-sharing) and musyarakah (joint venture) concepts which nowadays are becoming an accepted way of doing business in several Western multinational banks. An overall comparison of the advantages of Islamic vs. conventional banking is also given. Islamic finance technology solutions have matured and they will face various challenges in the following decades, due to conventional banks offering, increasingly, Islamic products. The need for a more comprehensive environment and regulatory framework is emphasized, so that Islamic banking development can be ensured.

Keywords: Islamic, law, finance, banks, growth.

Jel Classification: G20; K22; K33

INTRODUCTION

The rapid growth of Islamic banking and finance, as a financial system that respects the Islamic standards, has captured much interest (Daily, Frigha, and McMillan 2016). The Islamic finance industry has grown considerably over the last two decades and Islamic financing transactions today often have a global reach (Balz 2004). According to Banker the first Top 500 Islamic Financial Institution (TIFI) listing shows that the total of Shariah-compliant assets, based on the latest official figures, have grown by 29.7% over the past year (2011) to reach $500,482 m (Daly and Frikha 2016). This unconventional form of banking is based on that fundamental standing of Sharia[2] (Islamic law) with a

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[2] Quran strongly condemns interest. In its verses, it stipulates, “Those who swallow usury (riba) cannot arise except as one whom the devil prostrates by (his) touch.” (2275) “But if you do (it) not, (i.e. continue to

great emphasis of its ethical and spiritual values as well as religious dimension with the aim of achieving equality in society, for the benefit of society as a whole. In view of the above, the objectives of Islamic banking are to promote, foster and develop the application of Islamic principles, law and tradition to the transaction of financial, banking and related business affairs services and to promote products based on Islamic principles (Ahmad, and Kabir 2007) Hence, the principles of Islamic banking and finance enshrined from alQur'an and Prophetic Sunnah are quite simple and can be summed up as follows:

- Any predetermined payment over and above the actual amount of principal is prohibited;
- The lender must share in the profits or losses arising out of the enterprise for which the money was lent;
- Making money from money is not Islamically acceptable;
- Gharar (deception) and Maisir (gambling) are also prohibited;
- Investments should only support practices or products that are not forbidden or even discouraged by Islam (Ibid).

While these principles were used as the basis for a flourishing economy in earlier times, it is only in the late 20th century that a number of Islamic banks were formed to provide an alternative basis to Muslims although Islamic banking is not restricted to Muslims (Institute of Islamic Banking and Insurance 2017). In particular, Islamic banks were founded to fund trading activity and in this regard, the first modern Islamic banking institutions were farmer credit unions founded in Pakistan in the 1950s and a small rural institution founded in Egypt in 1963 (Esposito 2002). This so called Mid Ghamr Saving Bank did not charge interest but has invested in trade and industry, either directly or in partnership. In other words, the bank applied the PLS principle in its work, which according to the Islamic theologians has been recognized as halal method of banking (i.e. in accordance with the Qur'anic approach). Although existed in a very short period of time, due to political reasons and under the Egyptian Government and Central Bank[3] pressures to convert into conventional type of banks, the Mid Ghamr Saving Bank succeeded to attain remarkable results in its work. Islamic banking expanded in the 1970s with the founding of the Dubai Islamic Bank (1975), the Faysal Islamic Banks in Egypt and Sudan and the Kuwait Finance House (1977), the Jordan Islamic Bank (1978), and the Bahrain Islamic Bank (1978) and then spread to Malaysia and Indonesia (Ibid). Since the 1970s, some commercial banks in Europe, such as Great Britain, Luxembourg and Switzerland started Islamic banking services, through so called "Islamic-windows".

The liberalization of financial regulations, financial globalization, changes in technology, product innovation, the birth of several new Islamic markets, and the most notable of them is the financial crises stimulate the spread of the IF (Mohsin and Azmi 2016).

Nowadays, Sharia based banking and investment services are executed in several ways (Ibid):

- Islamic Bank provides services in the Muslim countries markets;

take riba), then be apprised of war from Allah and His Messenger; and if you repent, then you shall have your capital. Wrong not and you shall not be wronged (2279).

[3] The social circumstances in that time were not inclined to the „new approach" i.e. the islamic banking this the establishment of this kind of Bank upon the Shariah principles was considered utopian.

- Islamic bank is established in the west and offers its clients the services of Islamic Banking and investment;
- Islamic Bank through the western conventional banks offers its clients Islamic banking services.

Furthermore, the Western banks are significant participants in the Islamic trade by offering Shari'ah compliant investment products in order to attract capital and take advantage of liquidity of the "newly discovered" market. Thus, the American Citibank was the first conventional bank that was involved with operating capital of $ 20 million for the establishment of Islamic banks in Bahrain and although it looks like a "small amount" it shows that the conventional banks achieved concrete cooperation with Islamic banks (Ibid).

Despite the rising grow in the global market, the further development of the Islamic financial institutions will depend on how successfully- the existing Islamic banks can develop capabilities in finding a solution for their own shortcomings that we will mention below.

1. THEORETICAL FOUNDATIONS OF ISLAMIC BANKING

Elimination of interest or fees for loans of money (an ancient Arabian practice known as riba, or usury) in all its forms is fundamental feature of the Islamic financial system. What constitutes riba, has, however, been a subject evoking deliberation and debate over the centuries that followed divine revelation (Siddiqi 2004). The majority of scholars, however, thinks that it covers the interest stipulated at the time of the contact in case of loans as well as the subsequent increases in case the loan or the debt arising from sale on credit is rolled over because the debtor does not pay it at the time stipulated in the contract (Badawi 1964).

However, it is not just Islam, but in many religious[4], philosophical, ideological teachings, interest is considered unacceptable way of gaining money or wealth. Upon Plato “In marrying and giving in marriage, no one shall give or receive any dowry at all; and no one shall deposit money with another whom he does not trust as a friend, nor shall he lend money upon interest; and the borrower should be under no obligation to repay either capital or interest.” (Plato 2016). In his Book “Politics” Aristotle stated: „The most hated sort (of wealth-getting), and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural object of it. For money was intended to be used in exchange, but not to increase at interest. And this term interest, which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefore of any modes of getting wealth this is the most unnatural” (Aristotle 1932). Long is the list of famous writers and scholars to stay against the interest: Shakespeare (The Merchant of Venice), … the classics of the modern economic thought Adam Smith and David Ricardo as well as the Marxist views on the value and surplus value resulting from work.

Yet, there are many Islamic scholars and modern commentators of the Quran who translate riba as usury and not as simple banking interest, prohibited by Islam. Muslim

[4] For the world's major religions - Judaism, Christianity and Islam, interest based business is a sin because one is making money without work and without effort, and God is not satisfied at all with it.

scholars like Fazlur Rahman (1964), Muhammad Asad (1984), Said al-Najjar (1989), Sayyid Tantawi (1997) and others for whom it appears that prohibition of riba is due to the exploitation of the needy, rather than the concept of the interest rate itself (Ahmad, and Kabir 2007) Keeping this in view, many of them attempt to differentiate between various forms of riba practised under the conventional banking system, advocating the lawfulness of some and rejecting others (Ibid).

Regardless of the critics, it is widely accepted fact that the prohibition of riba is part of Islam's broad vision of a moral economy. In Islamic economics, the lender should bear the risk of the venture with the borrower because it is deemed that neither the borrower nor lender is in control of the success or failure of a venture (Chong and Liu 2009). This profit-and-loss sharing (PLS) paradigm is the main difference between the Islamic banking and conventional banking. Islamic bank financing, which adheres to the PLS principle, is typically structured along the lines of two major types of contracts: musyarakah (joint venture) and mudarabah (profit-sharing) (Ibid).

Table 1. Types of contracts – musyarakah (joint venture) and mudarabah (profit-sharing)

Mudarabah	Musharakah
Investment is the sole responsibility of rabb-ul-maal, not all partners.	Investment comes from all the partners.
The rabb-ul-maal has no right to participate in the management which is carried out by the mudarib only.	All the partners can participate in the management of the business and can work for it.
The loss, if any, is suffered by the rabb-ul-mal only, because the mudarib does not invest anything. His loss is restricted to the fact that his labor has gone in vain and his work has not brought any fruit to him.	All the partners share the loss to the extent of the ratio of their investment.
All the goods purchased by the mudarib are solely owned by the rabb-ul-maal, and the mudarib can earn his share in the profit only in case he sells the goods profitably. Therefore, he is not entitled to claim his share in the assets themselves, even if their value has increased.	As soon as the partners mix up their capital in a joint pool, all the assets of the musharakah become jointly owned by all of them according to the proportion of their respective investment. Therefore, each one of them can benefit from the appreciation in the value of the assets, even if profit has not accrued through sales.

Basically, in terms of language, musharakah is a word taken from the Arabic verb sharika, sharikah or shirkah means mixing property or partnership contains the meaning ikhtilat; the mixing of something with another that is mixing two parts so that it cannot be differentiated any more (Saripudin et al. 2012). Musharakah is often used in investment projects, letters of credit, and the purchase or real estate or property. In the case of real estate or property, the bank assesses an imputed rent and will share it as agreed in advance (Farhad and Rahnema 1994). On the other hand, mudarabah is a pre-Islamic, Arabic type of finance in which one individual provides start-up capital to another individual who will do the actual work (Daly and Frikha 2016). As a financial agreement between the financier and an entrepreneur, a one-tired mudaraba exists; a two mudaraba modifies this by introducing an intermediary between these two principles (Ibid). A very exausting and comprehensive distinction between these two models has been given by Mufti Taqi Usmani, 1998 (Table 1).

Although the most theoretical models of Islamic banking are based on the mudarabah (profit-sharing) and/or musyarakah (joint venture) are the most frequently used models of Islamic banking, there are, however, other financing contracts that are permissible in Islam but not strictly PLS in nature, such as: financial contracts, based on murabaha (cost plus), ijarah (leasing), bai' muajjal (deferred payment sale), bai' salam (forward sale), and istisna (contract manufacturing) concepts (Chong and Liu 2009). Their acceptability is

however broadly contested mainly due to their close similarity with the conventional interest-based financing methods.

2. CONVENTIONAL VS. ISLAMIC BANKING

Conventional banking system is dominating the global finance market. However, many international and local banks have stepped into the Shariah-compliant financial industry by establishing Islamic units in their existing banking system.

The Islamic banking was first limited to Middle Eastern countries. But over the years, it has become an effective tool for finance development worldwide including non-Muslim countries by becoming a more than $2 trillion market at the global level.

There are few key advantages of Islamic banking. Firstly, it is based on financial justice as a main principle of the Islamic model (Ahmed 2010). Islamic banking creates a balance for the net profit or loss between the lender and the beneficiary rather than give it all on the entrepreneur. The output of the project financed by the Islamic bank will be equally distributed among both sides. The financier should not be expecting to receive only profit for a certain project, but he should also agree to carry a share of the loss. Secondly, Islamic banking founds on financial inclusion (Ahmed et al. 2015). Muslims keep back from conventional banking system since it is based on paying/receiving an interest which is strictly prohibited by the Shariah Law. Approximately, three-quarter of the Muslims remain outside the banking system. Islamic banking or the banking without interest allows Muslims to use the financial system. Thirdly, Islamic banking diminishes the influence of harmful products and practices because it restricts the goods and services that are restricted in Islam. Fourthly, Islamic banking enhances financial stability. It means that the decision-making process for investment is carefully effectuated. Therefore, due to detailed analysis and revisions, the Islamic financial institutes remained generally untouched during the global financial crisis. Finally, Islamic banking is based on ethical and moral values as important characteristics in promoting socially eligible investments and better individual and corporate behavior.

Islamic banking as an alternative banking system is suitable and draws attention to both Muslims and non-Muslims due to its unique principles.

Table 2. Characteristics of conventional and Islamic banking

Conventional Banking	Islamic Banking
Money is a commodity besides medium of exchange and store of value. Therefore, it can be sold at a price higher than its face value and it can also be rented out.	Money is not a commodity though it is used as a medium of exchange and store of value. Therefore, it cannot be sold at a price higher than its face value or rented out.
Time value is the basis for charging interest on capital.	Profit on trade of goods or charging on providing service is the basis for earning profit.
Interest is charged even in case the organization suffers losses by using banks funds. Therefore, it is not based on profit and loss sharing.	Islamic bank operates on the basis of profit and loss sharing. In case, the businessman has suffered losses, the bank will share these losses based on the mode of finance used (Mudarabah, Musharakah).
While disbursing cash finance, running finance or working capital finance, no agreement for exchange of goods & services is made.	The execution of agreements for the exchange of goods & services is a must, while disbursing funds under Murabaha, Salam & Istisna contracts.
Conventional banks use money as a commodity which leads to inflation.	Islamic banking tends to create link with the real sectors of the economic system by using trade related activities. Since, the money is linked with the real assets therefore it contributes directly in the economic development.

Also, there is difference in the case of mortgage between the conventional and Islamic banks (Shubber 2008). In conventional mortgage, the client borrows money from the bank in order to buy a property and repays it with an additional amount of interest over a period of time. Seeing that the interest is against the Shariah Law, in Islamic mortgage, the bank shares the purchase of the property with the client. Accordingly, the client and the Islamic bank become joint owners of the property in proportion to the share in purchasing the property. In order to fully own the property, the client should buy the share of banks' property over a period of time but needs to pay the rent for using the banks' share of the property.

3. ANALYSIS OF ISLAMIC FINANCE IN GLOBAL CONTEXT

Islamic finance is the provision of financial services that are compliant with Sharia law. According to the IMF's definition, Sharia does not allow the payment or receipt of interest (riba), gambling (maysir) or excessive uncertainty (gharar). The investing techniques such as short selling (betting against a security) are forbidden and all transactions must show an economic purpose. The funding of islamic banks comes from deposits (on which they pay no interest) and profit-sharing investment accounts with a return according to the bank's profit. Sukuk are structured so that the returns are linked to the underlying asset, with the lender receiving a claim on the asset in return (rather like asset-backed securities).

The key countries involved in the Islamic finance, which account for the majority of assets, are the GCC countries (Yusof and Bahlous 2013). Gulf Cooperation Council (GCC) is a regional intergovernmental political and economic union consisting of all Arab states of the Persian Gulf, except for Iraq. Its member states are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The Islamic finance model is also making headway in other countries, such as Malaysia, Indonesia, Turkey and Pakistan.

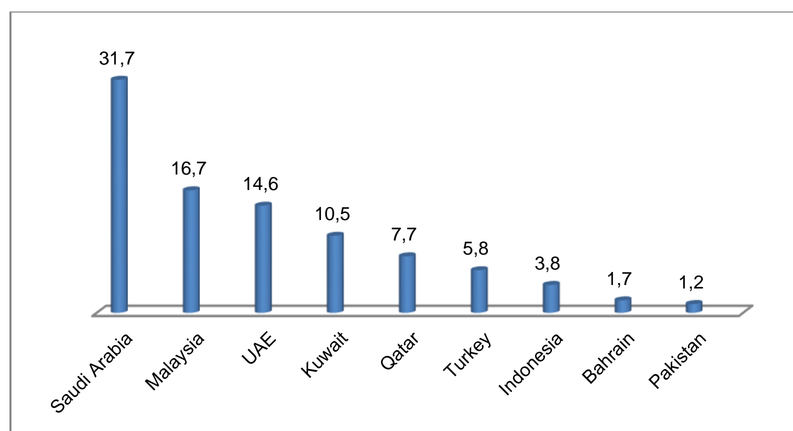

Figure 1. Global share of Islamic finance banking assets in percent for 2015
Source: Ernst & Young

According to Ernst & Young, Islamic banking assets grew at an annual rate of 17.6% between 2009 and 2013, and will grow by an average of 19.7% a year to 2018. Gulf Cooperation Council (GCC) countries account for around $517 billion, ASEAN countries for $160 billion and South Asia for $23 billion; with the rest of the world (especially Turkey) making up the remaining $78 billion.

The share of Islamic financial assets remains a small part of global financial assets (less than 1%). However, its growth is outpacing that of conventional banking and it is increasing with Sukuk issuance in Africa, South Asia and Europe. Unfortunately, while the industry is growing, its profitability is far behind that of conventional banking institutions. Average return on equity in Islamic finance banks was 11.9% in 2009 to 2013, and 14.5% return from traditional banks.

In many Muslim countries (Mohsin and Azmi 2016) Islamic banking assets have been growing faster than conventional banking assets. However, there has been an interest in Islamic finance from non-Muslim countries such as the UK, Luxembourg, South Africa, and Hong Kong.

The World Bank Group involvement in Islamic finance is linked to the Bank’s work on reducing poverty, expanding access to finance, developing the financial sector, and building financial sector stability and resilience in client countries.

By helping expand the use of Sharia-compliant modes of financing, the World Bank is helping deliver benefits to client countries in three areas:

- Islamic finance offers benefits for economic growth, reducing poverty and fostering shared prosperity;
- Islamic finance helps promote financial sector development and broadens financial inclusion;
- Islamic finance helps strengthen financial stability.

In recent operations in Egypt and Turkey, the Bank Group helped governments to design Sharia-compliant financing frameworks to expand financing for small and medium scale enterprises.

In July 2015, the World Bank and the General Council for Islamic Banks and Financial Institutions (CIBAFI), the global umbrella of Islamic financial institutions, signed a Memorandum of Understanding (MoU) to help foster the development of Islamic finance globally and expand its use as an effective tool for financing development worldwide, including in non-Muslim countries.

Islamic finance will continue progressing and maintain growth in 2017 (Zarrouk, El Ghak, and Al Haija 2017) due to positive economic growth of core markets, the continuous demand from an expanding customer base, a broader consensus around the need to standardize legal structures and Sharia interpretation, and the industry's potential contribution to the United Nation's sustainable development financing goals. It is expected the industry to be worth of $3 trillion sometime in the next decade.

The statistics show that the lower economic growth means lower growth opportunities for Islamic banks. The decline started in 2015, when Islamic banks' asset growth fell to around 7% compared with 12% in 2014. The slowdown persisted in 2016 and in 2017 is predicted that the growth will stabilize at around 5%. Lower oil prices mean lower liquidity at Islamic and conventional banks in core markets.

The International monetary fund emphases the need of appropriate regulations of these institutions due to the risks related to the business model. This issue involves managing liquidity risk and dealing with the complexity of transactions and corporate structures

required for Sukuk issuance. However, Islamic finance will continue its growth in following years and the profit gap compared to conventional banking will decrease.

CONCLUSION

Islamic finance has core principles that are very important and acceptable for everyone, equity-based, asset-backed, ethical, sustainable, environmentally and socially-responsible finance. It encourages risk sharing, enhances the connection between the financial sector and the real economy, and emphasizes financial inclusion and social welfare.

The Islamic finance is guided by few key principles: prohibition of interest on transactions (riba); financing linked to real assets (materiality); prohibition of engagement in non-ethical businesses; returns linked to risks.

Despite its recent growth, Islamic finance is in early development, and it will face future challenges. World Bank and IMF support the strengthening of the legal and institutional foundations of Islamic finance. They are promoting the awareness and relevant knowledge of Islamic finance and worldwide use of Sharia compliant financing instruments.

Modern Islamic finance began in the 1960s but it became largely significant in the last 20 years when banks started to offer sophisticated Islamic products and finance arrangements. Islamic Banking has grown rapidly in value and geographical reach, and has become an important and integral part of the financial systems in many countries. Islamic Banks currently operate in more than 60 countries and the industry has become systemically important in 14 jurisdictions.

Today, Islamic finance technology solutions have matured and there will be various challenges that a financial institution might face when considering opening an Islamic bank or just a window operation, i.e. a conventional bank offering Islamic products.

Islamic banking will continue to grow in size and complexity, posing a challenge to supervisory authorities and central banks. The current framework governing Islamic banking contains gaps that need to be closed through the development of a more comprehensive environment that will ensure the financial stability and sound development of the Islamic banking.

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