

MARIAM TSINTSADZE  
FREE UNIVERSITY OF TBILISI  
mtsint20@freeuni.edu.ge

## THE INFLUENCE OF RELIGION ON THE ECONOMY IN THE EXAMPLE OF THE ISLAMIC BANK

### Abstract

The influence of religion in the organization of states and the arrangement of policy has been clearly outlined over centuries. However, it's interesting that its role has especially increased regarding the economy and finances. The most obvious example of this is an Islamic bank model. The Islamic bank is no longer a new phenomenon in the world, which nowadays crosses the borders of Islamic countries.

The first attempt to create a modern Islamic bank was in Egypt in 1963. By 1967, there were already nine such non-commercial banks operating in the country. However, the first initials can still be seen from the time of Prophet Muhammad. After that, in the 70s of the 20<sup>th</sup> century, along with the change in the political background in the Middle East, essentially different financial institutions appeared one after another in the region. Their model tries to break the specifics of the Western banking system introduced at the beginning of the 20<sup>th</sup> century and is based not only on economic but also on religious laws (Hassan and Lewis 2007b).

The article reviews the concept of an Islamic bank with its religious and financial characteristics. At first glance, an impossible collaboration between the elementary principles of profit-making and Sharia laws has been proven to the world for several decades that it has successfully taken place. Its evidence is the tendency of Islamic banks to spread not only in the Middle East and the Muslim world but also in Europe and America (Noland and Paek 2007).

**Keywords:** religion, finance, Islamic banking, *Riba* (ربا) – interest rate, PLS – Profit and Loss Sharing.

### Religious Concepts

Islam forbids using interest rates for both giving and receiving money, regardless of the purposes or reasons. Islamic banks use the term “*Riba*” (ربا) to match the term “interest rate”. *Riba* in Arabic means to increase, to exceed, and is usually used in cases of unequal exchange. So, it is perceived as unfair, exploitative profit, which Islam strictly forbids. Obviously, over the centuries, there have been many attempts to distinguish between *Riba* and the rate of interest, but no meaningful argument has been found, so the two terms are still used interchangeably (Ariff 1988, 3-5).

The prohibition of *Riba* in the Quran is mentioned in 4 different revelations<sup>1</sup>. In Surah “*Al-Baqarah*”, the largest place is given to this matter, and the moneylenders are in a way equated with those whom “Shaitan has driven mad with his touch” because just like them they will be resurrected on the day of judgment. Here, trade and usury are distinguished from each other. Trade is permitted by Allah, and *Riba* is forbidden. The Quran contrasts *Riba* with *Zakat* and appeals to believers to give charity in return, and those who still do not follow this dogma of Islam are doomed to severe punishment. It is significant that the Quran urges the believers to renounce *Riba* for their own welfare, as they will only benefit from the amount that is rightfully theirs, and also urges them to renounce the amount taken from a poor debtor, which will also be considered as *Zakat* (Lobzhanidze 2006; Quran n.d.).

*Riba* is also prohibited in Hadith. The Prophet Muhammad, in this case, condemns not only the taker and the giver of the interest rate but also the participation in any way in the transaction, whether as a witness or the compiler or recorder of the transaction. Considering all this, every Muslim working in a

<sup>1</sup> 2: 275 - 2:2 80; 3: 125(130); 4: 159(161); 30: 38(39).

non-Islamic bank becomes a sinner because he/she is directly or indirectly related to usury (Esposito 2011).

It is important that the prohibition of *Riba* does not mean that the phenomenon of capital is also unacceptable in Islam. In fact, Islam recognizes capital as a form of production and profit but not as a pre-determined rate of interest (Ariff 1988). So, the owner of the capital has the right to receive only an uncertain profit and does not have the right to demand a fixed amount. This principle is called *Mudarabah* (مضاربة), which was still acting during the period of *Jāhiliyyah*. Prophet Muhammad brought it to Islam. *Musharakah* (مشاركة or مشرقة) and *Murabaha* (مرابحة) are also among the principles spread in Islam, the difference of which from *Riba* is still an actual issue (Islahi 2008). Although the concept of the latter and its difference from *Riba* was not clear even to the orthodox Muslims themselves, they are distinguished both in the Quran and in the Hadith, *Riba* is mentioned as Haram, i.e., illegal, and *Murabaha* is perceived as Halal (legal) and one of the accompanying phenomena of trade. It is also important that *Murabaha* is allowed in the sayings of the Prophet Muhammad, and according to the Hadith, the Prophet Muhammad also benefited from the principle of *Murabaha* (Khan 2010).

In general, receiving or giving pre-determined benefits is not acceptable in Islam, although, of course, this does not mean that the desire for profit and receiving it is a sin. As we have seen, there are many ways to turn the existing capital into a source of additional income and, at the same time, more fairly, as the Islamic model proves. In 1983, the Supreme Supervisory Council of Fatwa and Shariah was created in order to control all this. The Council was driven by several main goals. The main objective of it was to monitor the activities of the existing Islamic banks, to ensure their international cooperation, their compliance with Sharia laws, and to carry out active actions in case of any kind of violation or deviation. The commission had the authority to issue a legal opinion on the bank's activities as provided by Sharia. Today, the activity of the commission is terminated, as each Islamic bank has its own Shariah Advisory Committee to give them advice and ensure that their operations and activities comply with Shariah principles (Alharbi 2015, 17-23).

### Islamic Bank Financial Structure

Considering the religious characteristics, the distinguishability of the Islamic bank is revealed in the fact that it does not consider interest, is multifunctional and not exclusively commercial, and is strictly capital-oriented (Ariff 1988). Each of the above-mentioned religious doctrines was translated into the so-called PLS – Profit and Loss Allocation System and is based on *Mudarabah* and *Musharakah*. PLS does not use terms such as debt, loan, or creditor (Hassan and Lewis 2007a). Its structure can be compared to a kind of joint venture, where partners share both losses and profits based on ownership. Mohammad Nejatullah Siddiqi, a distinguished scholar of the Islamic financial system, proposes a two-step model of PLS as the basis for *Riba*-free banking (Siddiqi 1983). The foundation of the model, on which a whole Islamic bank system should be built, is *Mudarabah*, and the second level is divided into *Murabaha*, cash advances for the purchase of agricultural products and the production of assets, the same as *Istisna'* (إستصناع) and lease, which is distinguished from *Riba* and is characterized as rent. In banking, a lease works as follows: banks buy necessary equipment or other goods and then lease them to customers, who can either keep the product in perpetual possession or rent it, which means paying a monthly fee. In both cases, the renter has the right to use the product in any way, be it remodeling or re-renting, only in such a way that its original value is not changed. Accordingly, under the PLS paradigm, the assets and liabilities of Islamic banks are integrated in the sense that borrowers share profits and losses with banks, which in turn share profits and losses with depositors (Chong and Liu 2009).

Overall, the PLS paradigm incorporates the norms justified in the Quran and the Hadith, which are tailored to Islamic finance to benefit:

#### 1) *Mudarabah* (مضاربة)

It is a profit-sharing agreement between two or more parties. Participating parties are divided into two parts. For simplicity, if a partnership is formed between two persons, one is called *Rabbul-Mal* (رب المال), the other is called *Mudarib* (مذرب). *Rabbul-Mal* is a passive participant in the agreement, the one who owns some capital and invests in the business. So, *Rabbul-Mal* is the supplier or investor of the capital. As for *Mudarib*, he is the active party to the agreement. As the recipient of capital, he is the partner who actually leads the business – a kind of manager. For *Mudarabah* to be made, several requirements must be met. *Mudarabah* capital cannot become an unpaid debt owed by *Mudarib* to *Rabbul-Mal*. The profit distribution mechanism should be defined in advance so that uncertainty and

disputes do not arise later. Profit should be distributed not on the basis of capital but based on a percentage of profit. That is, the parties must agree on what part of the profit each will receive.

A *Mudarabah* contract involves profit sharing between the bank and the client, where, in one case, the bank plays the role of *Rabbul-Mal*, and the client plays the role of *Mudarib*. The bank provides the financing capital of the project in total, while the client implements the project and leads its realization. The profit from the project is shared by both parties based on a predetermined and agreed-upon fixed ratio. In case of loss, the entire responsibility rests entirely with the bank. The *Mudarib* is violated only when the client's fault in the failure of the case is revealed.

As for savings accounts, bank accounts are also structured on the basis of *Mudarabah*. In this case, banks operate as *Mudarib* and customers as *Rabbul-Mal*. This capital is invested in various assets, of course, in accordance with the Shariah. The concept is also preserved here; the content and conditions of each *Mudarabah* participant are unchanged.

Islamic funds are also modeled according to *Mudarabah*; the profit is distributed proportionally between the investor and the bank (Iqbal and Mirakhor 2011).

## 2) *Musharakah* (مشاركة)

The structure of *Musharakah* does not consider the substantive difference between the parties. Each active partner must own the initial capital and invest in the business – must be an investor. The profit and any kind of loss must be distributed among them in proportion to the initial capital.

According to *Musharakah* contracts, the bank and the entrepreneur jointly invest capital in the project and accordingly share the duties of its management. The profit received from the business project (both positive and negative) is distributed according to a predetermined rule. The joint venture established as a result is an independent legal entity, and the bank has the right to terminate the cooperation gradually, after a certain period, or after fulfilling the conditions.

## 3) *Murabaha* (مرايحة)

According to the *Murabaha* contract, the bank is obliged to purchase goods for the customer and sell them at a pre-agreed price that exceeds the purchase price and is the initial cost plus the bank's profit. *Murabaha* also provides for postponed payment in the case when the delivery of the goods is immediate from the bank, and the payment of the amount is postponed by the client either partially or completely. The main difference is that the added amount does not have the form of interest, is agreed upon in advance, and is not subject to change and uncertainty. Mainly in Islamic banking practice, *Murabaha* is used to finance housing and other immovable or movable property (Iqbal and Mirakhor 2011, 75-92).

## 4) *Istisna'* (استصناع)

*Istisna'* contracts usually provide a long-term sales contract between the bank and the customer. *Istisna'* is one of the most widely used, profitable concepts for Islamic banks. It mainly specializes in construction, be it residential buildings, shopping malls, villas, airplanes, ships, cars, or more. In this case, the bank undertakes to produce specific goods, for example, to build a residential complex at a predetermined price, which the client will pay at a specified time (Chong and Liu 2009).

Obviously, this is an incomplete list of elements necessary for the functioning of an Islamic bank, although it contains all the fundamental concepts that emphasize the uniqueness of the Islamic finance system.

## Islamic Banks Around the World

Today, Islamic banking is not only the domain of Islamic countries, but it is found in more than 50 countries all around the world. In these countries, Islamic banks coexist with traditional banks and deal with their competition, which already indicates their success. Obviously, it is important to take into account the share of Muslims in the world's population. Their number currently exceeds two billion people, which is approximately a quarter of the world's population, and makes Islam the second most widespread religion after Christianity.

Logically, the main part of Islamic banks is concentrated in the Middle East; however, for an objective assessment of their work, a study of banks outside its borders is necessary. In 2004, British Islamic Bank became the first bank licensed by a non-Muslim country and actively engaged in the Islamic banking system. Before that, in 1978, there was an attempt to introduce the Islamic banking system for the first time in the Western world, namely in Luxembourg. In 2005, the European Islamic Investment

Bank was also established, and as the annual dynamics show, the Islamic finance system is developing very quickly in Europe. A similar trend continues even now, and several leading European countries are already taking steps to implement the Islamic financial model (Alharbi 2015).

As for America, the introduction of the Islamic financial model in the United States began in Washington and California almost simultaneously, in 1986-1987. Since 1999, banks have been actively involved in certain financing operations based on *Murabaha*, and today *Musharakah* agreements are especially relevant. It is significant that Devon Bank, founded by a Jewish family in Chicago, has been one of the leading Islamic banks in the region for years. Islamic Bank is not complaining about its popularity in Canada either (Alharbi 2015).

The Islamic financial structure of Malaysia and the Islamic banks operating there should be noted separately. The first Islamic financial institution in Malaysia was established in 1983. Before that, in 1963, a kind of savings corporation was established, the purpose of which was to help people perform Hajj. Today, it is considered to be the center of the Islamic finance industry. So, Malaysia is often the main object of observation for researchers of the Islamic banking concept (Mokhtar, Abdullah, and Al-Habshi 2006).

The research question should usually be about the challenges faced by Islamic banks, their prospects, and their consequences, although the most frequently asked questions are: Is there really a difference between the Islamic banking model and the conventional banking model, or is its uniqueness limited to unknown terms? Or does an Islamic bank comply with the norms imposed by Sharia law or just gracefully sidestep it? And what is the reason for its success? Does the Islamic model have any relative advantage over the traditional one (Azmat, Skully, and Brown 2015)?

Overall, the answers are always in the numbers, especially when it comes to banking and finance. Each research question asked above indeed requires thorough research and deep analysis; however, based on the available data, it can be said that the Islamic Bank is an important component of the global financial system, and the challenges it faces are outweighed by its positive prospects (Abedifar, Molyneux, and Tarazi 2013). The influence of religion on the economy and finance is really important and multifaceted, but mostly behind the scenes.

## References:

- Abedifar, Pejman, Philip Molyneux, and Amine Tarazi. 2013. "Risk in Islamic Banking." *Review of Finance*, Vol. 17, Issue 6 (November): 2035-2096. <https://doi.org/10.1093/rof/rfs041>.
- Alharbi, Ahmad. 2015. "Development of the Islamic Banking System." *Journal of Islamic Banking and Finance* (American Research Institute for Policy Development), Vol. 3, No. 1 (June): 12-25. [http://jibfnet.com/journals/jibf/Vol\\_3\\_No\\_1\\_June\\_2015/2.pdf](http://jibfnet.com/journals/jibf/Vol_3_No_1_June_2015/2.pdf).
- Ariff, Mohamed. 1988. "Islamic Banking." *Asian-Pacific Economic Literature (APEL)*, Vol. 2, No. 2 (September): 48-64. <https://onlinelibrary.wiley.com/doi/10.1111/j.1467-8411.1988.tb00200.x>.
- Azmat, Saad, Michael Skully, and Kym Brown. 2015. "Can Islamic Banking Ever Become Islamic?" *Pacific-Basin Finance Journal*, Vol. 34 (September): 253-272. <https://www.sciencedirect.com/science/article/abs/pii/S0927538X15000359>.
- Chong, Beng Soon, and Ming-Hua Liu. 2009. "Islamic Banking: Interest-Free or Interest-Based?" *Pacific-Basin Finance Journal*, Vol. 17, Issue 1 (January): 125-144. <https://www.sciencedirect.com/science/article/pii/S0927538X08000036>.
- Islahi, Abdul Azim. 2008. "Islamic Finance: Law, Economics and Practice by Mahmoud A. El-Gamal. Cambridge University Press, Cambridge, New York. 2006, 221 pp." *Journal of King Abdulaziz University - Islamic Economics*, Vol. 21, No. 2: 97-108.
- Esposito, John L. 2011. *What Everyone Needs to Know about Islam*. Oxford, New York: Oxford University Press.
- Hassan, M. Kabir, and Mervyn K. Lewis, eds. 2007a. "Glossary." In *Handbook of Islamic Banking*, xvii-xviii. Elgar Original Reference. Cheltenham, UK - Northampton, MA, USA: Edward Elgar.

- Hassan, M. Kabir, and Mervyn K. Lewis, 2007b. "Islamic Banking: An Introduction and Overview." In *Handbook of Islamic Banking*, edited by M. Kabir Hassan and Mervyn K. Lewis, 1-17. Elgar Original Reference. Cheltenham, UK - Northampton, MA, USA: Edward Elgar.
- Iqbal, Zamir, and Abbas Mirakhor. 2011. *An Introduction to Islamic Finance*. Singapore: John Wiley & Sons (Asia) Pte. Ltd.
- Khan, Feisal. 2010. "How 'Islamic' is Islamic Banking?" *Journal of Economic Behavior & Organization*, Vol. 76, Issue 3 (December): 805-820.  
<https://www.sciencedirect.com/science/article/abs/pii/S0167268110001940>.
- Lobzhanidze, George. 2006. *Quran*. Tbilisi: Kavkasiuri sakhli.
- Mokhtar, Hamim S. Ahmad, Naziruddin Abdullah, and Syed M. Al-Habshi. 2006. "Efficiency of Islamic Banking in Malaysia: A Stochastic Frontier Approach." *Journal of Economic Cooperation* 27, 2: 37-70.
- Noland, Marcus, and Howard Pack. 2007. *The Arab Economies in a Changing World*. Washington: Peter G. Peterson Institute for International Economics.
- Quran*. n.d. <https://quranonline.net/al-baqarah/> (accessed June 30, 2023).
- Siddiqi, Muhammad Nejatullah. 1983. *Issues in Islamic Banking*. London: The Islamic Foundation.