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Specific traits of Islamic law in relation to economic and financial systems

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Abstract

Islamic law is a legal system with a number of specific traits, which determine the path to the Islamic economic system. The Islamic banking system has been overlooked as an alternative to our financial system for years. The lack of interest to which it was exposed in the past clearly left a trace of misconceptions, with which we are accustomed to view it. It does not just concern the concept of our Western world banking in an Islamic environment. It is a system based on pillars, which are based on a very different historical context. The goal of the paper is to describe and explain the principles of the Islamic laws and the actual behaviour of the economy, as well as the economic entities formally operating under Islamic principles (mainly banks). Based on an understanding of the principles of Islamic law and the principles on which Islamic banks work and on an explanation of the banks' main characteristics, in particular the relationship with interest, loan usury and clarification of the method of profit gain, the paper aims to evaluate the effect of Islamic finance and outline the current practice in the light of compliance with the fundamentals of Islamic financial law.

Keywords

Islamic bank, Islamic economy, Islamic financial law, Islamic law.

JEL Classification: P40, P43, K00, G21, G22

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1. Introduction

Islamic law is a legal system with a number of specific traits. The characteristic approach of Islam, or Islamic law that tries to recreate the entire economic reality in a form corresponding to its visions, while itself it can adapt to the requirements of economic practice on a limited basis, opens up a number of issues. Islamic scholars often define the Western financial system critically in their publications. They can be accepted on a number of points. However, Islamic finance itself is not subjected to the same evaluative approach. The texts of many authors put effort into defending Islamic teachings uncritically without undertaking an objective comparison. This black and white view of the whole issue is inadmissible. The presented text seeks a partial remedy of the outlined state based on studying the interaction between the principles of Islamic law and Islamic finance. The goal of the paper is to analyse whether a contradiction exists between the requirements of Islam and the actual behaviour of the economy and economic entities formally operating under Islamic principles (mainly banks).

The first section of paper focuses on the general characteristics of Islamic law. Attention is especially paid to clarification of the philosophy that designs the Islamic economy. The fundamental principles of Islam that have an elementary influence on a theoretical form of the Islamic economic and financial system are highlighted in the second part of the paper. This hypothetical form is further developed in the third part. The final part of the paper focuses on demarcation of the inclusion of the current main features of the economic and financial realities in the theoretically determined form of Islamic economic organization.

The financial crisis has strengthened the voices calling for greater emphasis on the moral dimension of economic interaction. For example, Daňhel and Ducháčková (2010) state that: *... increase of motives for ethical behaviour of participants in the economic interactions appears to be necessary*. In this light, the Islamic point of view is very valuable and might offer welcome inspiration to reflect upon many economic dogmas. The professional community so far has not paid adequate attention to the issue of Islamic finance. As an exception can be mentioned, for example, the work of Weberová Babulíková (2001), who successfully describes the fundamental bases of Islamic banking and then compares them with the practise while identifying many diversions from the theory. It is also appropriate to point out the book by Hrdličková (2013), which focuses on the definition of the basic principles of Islamic finance and the description of fundamental financial products. Maitah (2010) describes Islamic finance and makes a comparison with its conventional counterpart in selected chapters. This author's opinion is in favour of a gradual convergence of Islamic finance with Western finance. The limited offer of the domestic literature is balanced by the rich variety of literature sources available in English. Primarily the work of Vogel et al. (1998) and from the current book the monographs by El-Gamal (2009) and Iqbal and Mirakhor (2011) should be underlined.

2. Characteristics of Islamic law

The beginning of the Islamic financial and economic principles dates to a turbulent period in the mid-twentieth century. The decline of the colonial system as well as the newly acquired freedom of many Muslim communities began a revival of the Muslim community. This was Islam, which has become a foundation stone for building a distinctive political, economic and financial system.

From the initial perspective, Islamic economics has an objective similar to that of its conventional counterpart, which is to support the optimal allocation of scarce resources. Kahf (undated) sees Western economics as a science that deals with material issues in relation to resources, services and goods. The fundamental difference of Islamic economics is quite clear from the definition by Chapra (1985), who describes it as: *... a branch of knowledge that helps realize human well-being through an allocation and distribution of scarce resources that is in conformity with Islamic teachings without unduly curbing individual freedom or creating continued macroeconomic and ecological imbalances*. Islamic economics must thus be understood not as an isolated concept but as one of the *instruments* of Islam on the path to building an ideal society based on both material and spiritual wealth: *A*

just economy is part of a just, healthy, and moral society, which is the central objective of Islam (Iqbal and Mirakhor, 2011). Similarly, the same approach can be followed when defining the Islamic financial system, which also cannot be seen in isolation, but in the context of Islam as a whole, while its task in economic terms is similar to that of its conventional counterpart, that is, to mediate the monetary flow in the economy.

The relationship of Islam with the economy and finance is based on a different philosophy. Western regulation aims to eliminate the market failures (for efficiency), to redistribute wealth within society (in the interest of justice) as well as to find a compromise between efficiency and equity (an effort to reach, or at least come close to, the point of bliss). The law is, therefore, an instrument with which the society regulates the spontaneous order of economics, and not only that. In the last three decades, the insight into the role of law in relation to economics has shifted more towards supporting the economy, especially on the North American continent. Here the interpretation of the law is understood as follows: *…the purpose of law should be to support market mechanisms that aim to increase the tangible goods of participants in market relations....* (Bělohlávek and Halfar, 2003). In the case of Islam, its primary sources are a masterpiece by God. Therefore, they are unchangeable, as are the resulting eternal principles. Regulation of the economy and finance is thus not only the result of Islam, but Islam itself, which is the fundamental building block.

As is apparent from the text above, the Islamic economic and financial system is built especially to be in accordance with Islamic law, which is: *... the preferred path to the Islamic economic system* (Weberová Babulíková, 2001). Hrdličková (2013) defines Islamic law itself as ... *set of certain standards, which Muslims believe were sent by God* …. The terms Islamic law and Sharia cannot be seen as synonyms. As stated by Vogel et al. (1998), *When referring to Islamic law, we usually always mean Fiqh, not Sharia*. While Sharia represents divine law that is perfect in every detail, Islamic jurisprudence, called Fiqh, is a human effort to understand the work of God. Sharia is thus based on the Quran and the Sunnah, i.e. primary, revealed sources. The word itself can be translated as *the way to the spring* or *the path to follow*. As emphasized by Vogel et al. (1998): *... while God knows its perfect law down to the last detail, people are in its interpretation often wrong, especially in partial detail*. Knowledge, skills and understanding derived from primary law through specific methods are then referred to as secondary law. Islamic financial law is the application of Sharia to financial and commercial transactions. Islamic banking, as we know it today, has not been the subject of classical Islamic law. However, the current growth of Islamic banking is not accompanied by a replacement or rewriting of Islamic law, but is accompanied by the effort of its application.

Anglo-Saxon law, which is created by judges, has many similarities to Islamic law, as evidenced by the judges. Despite this, Islamic law is considered to be the third major legal system – together with the continental European system (Boháček, 2004). Here, however, a paradoxical situation may arise. Many Muslim countries, such as Sudan and Pakistan, have a legal system that is designed along the lines of the continental European system. The effort to implement Islamic law, which is an accompanying phenomenon of the Islamization of financial regulation to a civil law system, therefore faces many problems (see Rosen, 2000). Islamic law is a religious law; its scope is not limited to application in specific areas, but is primarily intended for people of the Islam faith – Muslims, although some provisions are also targeted at non-Muslims, especially the so-called People of the Book (Christians and Jews). The Islamic law originates from and is inseparably associated with Islam. This is also evidenced by the fact that the terms *theologian* and *lawyer* are for the most part synonyms in the Islamic world. In reality, no country is governed by Islamic law unconditionally, although some countries have incorporated the Quran and Sunnah into their constitutional system.

The life of a Muslim is governed by Islam, which is not, however, a synonym for Islamic law. Islam includes several different sets of rules. The first group, known as Aqidah, governs the relationship between people and God. The second transforms the faith in God into the practice of everyday life. It is known as Sharia. The third group is Akhlaq, governing behaviour, attitudes and the work ethic. Sharia itself is further divided into two subgroups: Ibadat and Muamalat. The former focuses on the rites and rituals that lead a Muslim to an internal understanding with God. The second governs an economic life (not exclusively, as it also deals with other issues). However, the regulation of commerce and the Islamic financial and banking system lies precisely in this subset of Sharia (Iqbal and Mirakhor, 2011).

The sources of Islam can be divided into primary and secondary sources. There is no agreement on the summary and simultaneously on the division of the sources of Islam: *Some scholars refer to over 40 different sources, and others to only 15* (Bezoušková, 2008). The primary sources are the Quran and Sunnah (hadiths). The Quran was sent directly by God, and Sunnah is a collection of the Prophet's stories and at the same time is considered a source of law only in the case in which an obligation is deduced that is not included in the Quran in any way. Otherwise, it has an explanatory function. These two sources were com-

posed during the life of Muhammad. His death meant the completion of the first creation of the sources, despite some classification and arrangement of the Quran and writing of the hadiths taking place for some time afterwards. From the viewpoint of legal sources, verse 2:23[1] is controversial; according to some definitions, it also allows the use of Christian and Jewish saint texts. However, there is no agreement amongst Muslim authorities regarding the understanding of this verse, and thus it is an example of the occasional lack of clarity of the Quran.

The institute of fatwa has a fundamental role in Islamic law. This is not a source of law, but the opinion of an expert on Islamic law (mufti) regarding a particular problem. It is often issued in response to a direct question, but may also be published on the scholar's own initiative. It is necessary to ensure the credibility of fatwas, as the character of their individual opinion on a particular problem makes them prone to subjective interpretative differences.[2] Fatwas are not necessarily binding for Muslims. Their authority lies in the erudition of Islamic scholars, who try to give people instructions on how to behave as closely as possible to the message of God. It is thus in the interest of every Orthodox Muslim to listen to them, because God rewards those who follow his message faithfully. Fatwas play a crucial role in the Islamic finance sector. In 1979, the lawyer Ibn Shubruma issued a fatwa confirming the compliance of a Murabaha subtype with Islam, allowing the foundation of modern Islamic banking. In the contemporary Islamic finance sector, the institute of fatawas plays an important role. A fatawa is in many aspects similar to a fatwa, but it is issued by the members of the law council or internal supervisory authority (the Sharia Supervisory Board) on the initiative of lawyers, bankers and other parties interested in Islamic finance. The purpose of a fatawa is to confirm the compliance of a particular financial product with Sharia, through which its *purity* is declared (El-Gamal, 2009).

Within the context of the existing interpretation, the question arises of the ability of Islamic law to respond to the emerging challenges that inevitably occur hand in hand with the rapid development of society. Potměšil (2012) states in relation to this issue that ... *the Islamic law of God according to Islamic doctrine has been given to man once and for all – the company itself has to adapt to the law, rather than to create its own laws as a response to the ever-changing challenges of everyday life*. Where God expressed explicitly, there is no space for relativization. On the other hand, Muslims themselves admit that the message of God was in many aspects not sent in a completely clear and understandable form. Primary sources are often general and vague. Precisely this attribute is the advantage that allows Islam to respond to the development of the world: *The history so far has not recorded a case in which Muslim scholars were not able to provide solutions to a new problem* (Iqbal and Mirakhor, 2011). Thus, within the limits of interpretation, Islamic law is essentially flexible. However, still on the issue of the flexibility of Islamic law, there is no clear answer. As Hrdličková (2013) mentions: ... *among a number of scholars, the requirement for rigidity of Islamic law prevails*. Controversy exists inter alia in the possibilities of leaving the norms of Islamic law that were interpreted in favour of the new interpretation.

The role of Islamic law in the life of a Muslim is different from the role of law for a citizen in the Western concept. This is already apparent from the simple fact that Islam and its resulting rules reflect the will of the Creator, who is also the sole legislator. It is understandable, therefore, that the orthodox follower of Islam prefers it to the earthly standard. *Muslims cannot, in good faith, compartmentalize their behaviour into religious and secular dimensions, and their actions are always bound by the Sharia* (Hassan and Lewis, 2007). The difficulties in separating Islam and the state in countries where Islam is a dominant religion are completely understandable. Although indirectly resulting from the text above, it is appropriate to underline the fact that a Muslim must follow Islamic law even if he resides or stays in a non-Muslim country. Analogously, an Islamic bank operating in a non-Muslim country should preferably follow Islamic law over the secular law effective in the given state. Trakic (2012) reflects this fact, stating that: ... *Islamic banking products ... are in the first place Shari'ah compliant and secondly ... are in accordance with the EU legislative*. The incompatibility of Islamic law and the banking regulations of the country where the Islamic bank would like to expand its business is not an acceptable argument for departure from the principles of Islam. Thus, the operation of the Islamic bank would not be feasible in such a country. Also different is the structure of a legal standard itself. The standard's *ideal* does not have the form of a concise, clear stand-

[1] *If in doubt about what we have sent down to our servant, then produce a sura similar to this one and call your witnesses beside Allah if you are truthful* (Hrbek, 2007, 2:23).

[2] For Orthodox Muslims, in order not to let themselves be seduced by a wrong fatwa, it is desirable to approach fatwas critically. The present opinion of the scholars needs to be assessed in terms of the reputation of its author and the evidence on which it relies. If more contradictory fatwas exist on a given question, it is appropriate to compare the presented evidence and arguments. A believer himself must accept the final decision, in accordance with his conscience, not a rational calculus.

ard, only governing unnecessary aspects in order to allow for the maximum possible level of freedom of an individual. The Islamic legal standards are designed to try to balance out the individual's life with God's will entirely and therefore: *... are aimed at a normative revision of all thinkable areas of human behaviour to the smallest details* (Potměšil, 2012). In this light, it is obvious that the legal users' needs are not a priority. The number of command standards does not count in the earthly punishment for their violation – the punishment is supposed to be carried out by God himself.

The unmistakable undertone resonating through Islam is a strong social orientation, solidarity with those in need, as well as a desire for justice. Although the principle of solidarity in Islamic economics is strong, it cannot be made to conform to socialism or communism: *... Islamic economics is based on the idea of justice and equality, but not egalitarianism* (Weberová Babulíková, 2001). In addition, the incomparability is underlined by the Islamic respect for private property. In general, Islam views wealth in a positive manner. Wealth is seen as a well-deserved reward for hard work and risk-taking, while poverty is the greatest threat to the preservation of Islam (Maitah, 2010). Muhammad himself dedicated part of his life to business and trading. Undoubtedly, therefore, he assumed that profit reflects the human desire to perform better and that it is a driving force behind both the individual and the entire economy. Consequently, Islam permits wealth, but only to the extent that it brings a benefit not only to a man himself: *... i.e. if the assets are not gathered only for the assets themselves* (Weberová Babulíková, 2001). Such a state does not bring relevant benefits either to its owner or to a society as a whole. Any excess[3] should be used for some pious work or charity (Hrbek, 2007).

3. Fundamental principles of Islam in relation to economics and finance

Sharia is the fundamental set of principles of Islamic finance and financial services. The literature, in an attempt to capture their essence, highlights several key principles. The paper follows this approach. As noted by Hrdličková (2013), Sharia is characterized in relation to finance by a number of prohibitions and restrictions: *Islamic finance is therefore de facto based on the principle of certain prohibitions, and so is often referred to as prohibitive. The purpose of compliance with the prohibitions is to allow an increase of permitted business operations.* El-Gamal (2009) perceives riba and gharar as the two main prohibitions. Another important limitation is maisir, which is also referred to as a defining feature of Islamic finance for example by Hassan and Lewis (2007) and Hrdličková (2013). Islam is more than just prohibitions. For the purposes of this paper, the following principles of Islamic finance and financial services are crucial:

- Prohibition of riba;
- Zakat;
- Maisir and gharar;
- Sharing of profits and losses;
- Halal and haram.

It should be emphasized that the behaviour of a Muslim must be in harmony with Islam across the whole range. It cannot succumb to the illusion that the above-mentioned list of principles provides a comprehensive list of the principles by which financial institutions, whether Muslim or Islamic, are governed.

Presently, the *prohibition of riba* is considered a synonym of the prohibition of interest. This is not entirely accurate. Unfortunately, the concept has no equivalent in English. Any attempt to translate it is doomed to be inaccurate. Riba in direct translation means *increase, addition, additional fee* (Hrdličková, 2012b). The word, however, is often confused with *rabi.ha*. This can be translated as profit or revenue (Hasan and Lewis, 2007). This gives the origin to the myth of cost-free Islamic banking (Hrdličková, 2012b). If we refer to Hrbek's or Nykl's translation of the Quran, we learn that this term is translated as usury. This is not accidental. The translation should be based on the practice applied during those times, as the Quran could have prohibited only what was common in the society and what Muhammad could have encountered. In pre-Islamic society, a debtor had two options at the time of maturity of his/her debt – either to pay it off or to request a deferral in exchange for doubling the debt. It is that convention that the Quran addresses: *You who believe! Do not make your living through usury producing a profit twice, instead fear your God, so you may be blessed* (Hrbek, 2007, 3:130). In the context of the time, this translation is appropriate because doubling the amount owed would even from today's perspective be seen as usury rather than interest. In addition, at the time of Muhammad reciting his verses, the monetary economy did not exist, and barter transactions were part of everyday life. Furthermore, because interest is defined as a reward for lending money, riba cannot, in this sense, be considered interest.

The primary sources do not provide a clear answer to the question of a precise definition of riba. There-

[3] Excess is defined as the difference between the needs of an individual and the wealth possessed. However, a subject of consideration is whether the excess defined as such can be reached considering the impossibility of the satisfaction of human needs.

fore, this *gap* has been interpreted in the secondary sources. In efforts to give clear content to the term, two opposing groups stood against each other – the reformists and the conservatives. The reformists generally defended the interpretation of riba as usury (excessive interest, not interest as such). However, the *winning* conservative stream strictly rejected the arguments of the reformists and labelled them as an attempt to circumvent Muhammad's words – hijal (loop, trick). Riba is mentioned in verses 2:275–279, 3:130, 4:161 and 30:39 of the Quran and in several hadiths. The most notable is the last of the verses (30:39), in which it is written: *What you take as usury, so that it brings multiplication taken from the assets of others, does not bring any interest with God.* Riba is again translated here as usury. However, the context implies that usury is considered to be such behaviour whereby one is enriched at the expense of others without one's own efforts: *Every profit is to be achieved through one's own efforts and on one's own account, and not by exploiting one's fellow man or at his expense, although these may be artfully obscured by financial phrases* (Hrbek, 2007). The conservatives used the argumentation based on the *spirit* of the primary sources. The mission is clear according to them – the profit should be based on the work or the risk taken (yet reasonable). However, interest, with its characteristic properties, goes against Muhammad's vision. The risk and effort, in the case of an interest-bearing loan, lie mainly on the shoulders of the debtor. Regardless of whether the money lent has increased in value, a debtor must pay, in addition to the principal sum, further remuneration to the capital owner. It was these arguments that led Islamic scholars to believe that it is necessary to perceive interest as riba.[4]

However, the riba concept itself has a broader meaning. Islamic law identifies two main subtypes of riba. These are riba al-qurud, which currently prohibits the use of interest in loans, and riba al-buyu, which is subject to usury in business transactions. Riba al-buyu is bound to the contractual relationship, in which the object of the contract is measured in units or can be considered. It is itself divided into two other types – riba al-fadl and riba al-nisa. The first of the pair includes the prohibition of unequal exchange, either in quantitative or in qualitative terms, of the same commodity at the same time (spot trading). The second is also an inadequate shift, but is not simultaneous[5] (Hasan and Lewis, 2007).

Islamic economists pay special attention to justification of the prohibition of interest. However, their arguments are burdened by the absence of an objective approach. They cannot be objective, since riba is not a *product* of economic efficiency, but a religious principle (Maitah, 2010). The conservatives, particularly for example Mohamad Báqir as-Sadr, were fully aware of the irreplaceable role of interest in the contemporary economy. Instead of trying to reform the existing conventional system, they came up with a new model that meets the requirements of Islam. The foundation stone was the construction of the new financial sector – this effort is mainly reflected in contemporary Islamic banking. Interest has been replaced by an alternative – the principle of sharing profits and losses.

Zakat is a religious tax. It expresses the often-mentioned emphasis on solidarity with those who are less successful. From the perspective of Islam, zakat is seen as a return of part of the assets enabled by God. At the same time, the rest of the assets, which are a reflection of a sinful desire to own, are purified in the eyes of God (Potměšil, 2012). The collection should in theory be voluntary, but even during the lifetime of Muhammad, it became rather an obligatory contribution. It raised the question of how many assets one should contribute. According to the Islamic philosophy, one should pay what one does not need to live, i.e. any excess. However, an amount determined thus is very problematic. On one hand, human needs are essentially non-satisfiable – fulfilling one need results in another need rising in parallel. On the other hand, it is obvious that this formulation leaves room for radical leftist thinking. There is always someone who feels authorized to define how much another person needs and what is the excess, which is subsequently confiscated. The issue of zakat was a central element of the discussions about the compatibility of Islam with communism. However, Muslims refused the option of gradual convergence towards radical leftist utopianism (Kropáček, 2003). A contribution defined in general as all excesses was very quickly replaced by a much

[4] The prohibition of interest is not unknown to European culture. Aristotle perceived money as sterile. In his opinion, the medium of exchange should be equivalent. Exchanging *money* for *money* cannot generate any profit for the lender, as this would be unfair. He thus understood lending at interest as evil as one party was enriched unreasonably at the expense of the other (Holman, 2005).

[5] In order for trade not to be subsumed under riba al-buyu, it is necessary to carry out transactions at the same time (as proclaimed by the Prophet: *There is no riba except with deferment* and *There is no riba in hand-to-hand transactions*), and when trading with goods of the same kind, the exchange must be equivalent: *Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like and equal for equal, payment being made hand to hand. If these classes differ, then sell as you wish if payment is made hand to hand* (Sahih Muslim Book 10, Hadith 3853).

more accurate definition. The zakat is still collected today. The amount is fixed at 2.5% of the assets, provided that it exceeds the minimum set limit, and is collected annually.

While it may seem that the importance of zakat lies mainly in the social or fiscal area, it has a significant overlap with finance. In the Quran, riba and zakat are put into contrast: *God will destroy usury (riba), but will pay alms (zakat)* (Hrbek, 2007, 2:276). However, from the financial point of view, it is not so contrasting. It is impossible for Islamic current accounts to pay interest (the prohibition of riba) or appreciate the money otherwise (the principle of sharing profits and losses). In terms of its nominal amount, the money deposited in current accounts loses 2.5% of its value every year.

Maisir was in pre-Islamic society a lottery gambling game, as can be inferred from the Quran verse 2:219: *They ask you about wine and the maisir game. Say: "In both lies grave sin and benefit to mankind. But their sin is graver than their benefit" – and in verse 5:90: ... Wine, maisir game, sacrificial stones and throwing lots of arrows are indeed abhorrent things from the work of Satan ...* Maisir can be translated as *an easy achievement without work* (Hrbek, 2007). In later times, the meaning of the word expanded to include all gambling.[6] The same conceptual extension fell on the prohibition of wine, which was later extended to the prohibition of all alcohol.

Although from the perspective of the financial system the prohibition of gambling may seem trivial, it is not. This principle has been very thoroughly expanded to cover all social relations, including economics and finance: *Islamic law ... forbids any business activities which contain any element of gambling* (Hassan and Lewis, 2007). If we look at the etymology of the word gambling it is characterized as: *Risky activities or business, whose actual outcome depends on lucky chance or a happy set of circumstances*.[7] In other words, any activity, the outcome of which cannot be affected by an entrepreneur or can be influenced only indirectly, is prohibited. The result of this is that the compatibility of Islamic financial law, for example, with financial derivatives[8] or conventional insurance business activities is excluded.

While riba and maisir are embedded directly in the Quran, in the case of gharar it is important to rely on the hadiths (Hassan and Lewis, 2007). The word gharar originates from Arabic and means uncertainty or a large and excessive risk in commercial transactions (Hrdličková, 2012b). Igbal and Mirakhor (2011) understand gharar as exposure to excessive risk and hazard in commercial transactions, due to either a lack of information or information asymmetry regarding the price, quality and quantity of consideration, data of delivery and the ability of the buyer or seller to fulfil the commitment. The principle of gharar has many consequences in the economic sphere. In the case of business relationships, it concerns a ban on the sale of an item subject to uncertainty in terms of its future existence (whether something will be successfully produced, caught, etc.) or its partial characteristics (for example whether something will be produced in sufficient quantity). An example can be a situation in which a merchant tries to sell a product that is not yet in his possession – fruit that has not yet ripened or still uncaught fish. The principle of gharar has an impact on the financial sector. Contrary to it are such situations in which one party makes use of the loss of another entity under conditions of uncertainty. Conventional insurance is therefore in contradiction not only to the principle of maisir, but to the principle of gharar – the insurance company earns from the insured even in the case when the harmful event does not occur. Similarly, the prohibition relates to speculation on stock markets, etc. A contractual relationship with the above-listed characteristics is invalid. On the other hand, it is clear that a certain degree of risk and uncertainty in human activity is often unavoidable, especially during business activities. In the words of Iqbal and Mirakhor (2011), *The prohibition of gharar sale (bay al-gharar) indicates that the contract, which is in breach of this principle, is defected ... Under such a sale can be classified a situation where gharar is a*

[6] Islam, somewhat illogically, also understands chess as gambling. The basis in this case is the Hadith: *Buraida reported on the authority of his father that Allah's Apostle (may peace be upon him) said: He who played chess is like one who dyed his hand with the flesh and blood of swine* (see *The Book of Poetry*, č. 5612).

[7] Meaning of the word *hazard*. Accessed on 25 April 2013. Available at: <http://www.synonyma.postis.org/hazard.html>.

[8] Jílek (2009) deals with the negative impact of derivatives with reference to their similarity to gambling, thus indirectly defending an Islamic approach to gambling in finance: *Their risk (of derivatives) is based, among others, on their inclusion of gambling in the economic area. The activities of productive people are focused on gambling and on how to win over the market instead of on a productive activity, i.e. the production of goods and services. As a result, economic units become less competitive in the market and lay off their employees, unemployment increases and the overall GDP is reduced. The hazard of some individuals affects ordinary people.*

core component.[9] *This type of sale is referred to as gharar sale and is unanimously prohibited. However, small (minority) gharar does not make the sales contract invalid because no contract is not entirely free from certain risk*. Subjective consideration of whether the uncertainty is acceptable is therefore often involved.

Sharing of profits and losses is a fundamental principle of Islamic economics determining its specific character. Money is viewed in an Islamic economy differently from in Western economies. The purpose is not to accumulate money, as such an activity is considered to be an act of injustice. The primary task of money is to arrange an exchange. In the context of the zakat and riba prohibitions, money in the Islamic economy loses the function of value preservation (Maitah, 2010). Money is seen as potential capital. It only becomes real capital when it is used in productive activities (Osina, 2012). Islamic economics understands the sale of money for money as something absurd and immoral, and this absurdity is represented by interest. It is in no way connected with the actual profitability of the business plan implemented: *According to the classical concept the lender receives the same interest in each case* (Smrčа, 2010). Interest, from the point of view of Islamic economics, represents an injustice, because the system based on it shows an exceptionally asymmetrical distribution of risk. The risk is not carried by the saver, who deposits money in the bank, because his/her money is in most cases adequately insured. Similarly, thanks to diversification and collateral, the risk of the bank is also significantly reduced. The truth is that in a system based on interest, the significant majority of the risk is carried on the shoulders of productive units – entrepreneurs. The interest is characterized by the fact that it is inextricably linked with money, not with real production and sales. In addition, it has no feedback on the success or failure of the entrepreneur. *The use of money to create more money prevents societal development* (Hrdličková, 2012b).[10]

The arguments that led Islamic lawmakers to prohibit interest are extremely important in determining the overall perceptions of profit in Islamic economics. Interest is condemned as unfair and exploitative. A system that should be in accordance with Islam must be based on cooperation and morality. The principle of sharing of profits and losses is a logical response to the philosophy of Islam, and this principle has been unforgettably reflected in the requirements for the products of local banks and has determined the character of Islamic finance as a whole.

The sharing of profits and losses changes the relationship of creditor and debtor. Instead of lending the funds for a pre-fixed rate, a *partnership* is created between them. If there is a profit, it can be divided according to a predetermined criterion. In the case of a loss, the creditor is also involved in covering it and the principal borrowed is thus proportionally reduced. A bank is extremely motivated to lend its money to projects that promise a high rate of returns. Islamic scholars believe that the allocation of resources in the economy will be so much more effective: Weberová paraphrases Siddigi by stating that *There is no reason to believe that the most profitable businesses will be those with rich owners. However, the conventional system cannot locate resources other than under this key, and therefore not to the most productive businesses, in which the system of profit sharing is successful* (Weberová Babulíková, 2001). In their view, such a system should be much less prone to inflation.[11]

The literal translation of the term halal is *lawful*. The opposite of the word halal is haram (Boček et al., 2003). Halal is considered to be everything that is in accordance with the Islamic religion and therefore also in accordance with Islamic law. The Orthodox Muslim should not digest or use anything that is not halal, although a breach is allowed in extreme situations, in which there are no other options. Halal cannot be viewed only as an indication of the allowed food, but more broadly as *thoughts, deeds and things that are permitted to Muslims and which do not bring with*

[9] This means that large, excessive risk is the main characteristic of such a contract. That is why, for example, insurance and derivatives (whether financial or commodity) are banned altogether – the risk and uncertainty are an integral part of them.

[10] The arguments of Islamic scholars for the prohibition of interest also resonate with the medieval Christian philosophy. As noted by Holman (2005) … *All scholastics thought usury as immoral and sinful. If profit of merchant was justifiable as a reward for his work and risk, thus lending money at interest was for them fully unjustified because it did not mean neither work nor risk for the moneylender. They did not see any reason that would justify the existence of interest.*

[11] This idea is worth considering. Money is primarily an instrument of trade. Money is not of a separate value since the value has been determined by the product that can be purchased with it. In a system based on interest, inflation occurs due to the failure of many projects. Although the loan does not create any value, it must be paid, including interest. A creditor becomes richer despite his/her profit not being based on a real increase of wealth in society. On the contrary, it is possible that the production decreases, because an entrepreneur will have to reduce the production, or will even fail. If we analyse the situation in the equation of exchange: $M \cdot V = \uparrow P \cdot \downarrow Q$.

them a religious sanction either in this world or in the Hereafter ....[12] Islamic finance, which functions in accordance with Islamic law, is halal. On the other hand, it cannot be said that non-Islamic banking is automatically haram. It is always important to analyse the product and examine its compatibility with Islamic law. One of the basic principles of Islam is *the permissibility of all things*. If something is not prohibited, and if it does not contradict Islamic law, it is understood to be allowed.

Haram can be translated as bans. Some of them are elaborated in primary law and others by legal science. The Quran mentions in particular the prohibition of eating carcasses, blood and pork, wine drinking, drunkenness, corruption and adultery.[13] If something is haram, it must not be the subject of buying and selling, even though it is not consumed by the Muslim himself. The Islamic legal system divides all human actions into one of five groups: (1) actions required by the Quran (fard, wajib), (2) recommended actions based on the Prophet's words and practice, (3) indifferent actions (Islam does not comment on them in any way), (4) despicable actions (makruh) and (5) forbidden actions (haram) (Potměšil, 2012).

Islamic financial law allows investment only in authorized areas. Those are considered the areas that are neither haram (prohibited) nor makruh (despicable). For an investment to be halal, both the form of service and the subject of investment must be in accordance with Islam. The form means the terms and conditions imposed by Islamic financial law on each product. The products must primarily respect the condition to avoid riba and excessive as well as speculative and risky activities (gharar and maisir). The investment must exclude in particular pork, gambling and betting, casino, alcohol and pornography. In assessing whether a given investment area is allowed or prohibited, it is also necessary to take into account the principle *Everything that leads to the prohibited is itself prohibited* (Al-Islam website, 2011). For example, no one can invest in pork production or build a property that in turn would be leased to a pork producer. The specificity of each investment leads to its individual assessment. The acceptability or unacceptability is assessed in Islamic banks by an internal group of Islamic scholars, and conclusions on the acceptability of the investment can differ not only between individual countries but also between banks in the same country.

4. Specific traits of Islamic economics and finance

As stated above, it is Islamic law that paves the way for an Islamic economic system. Therefore, its selected institutes outlined in the previous chapter resulted on one hand in the prohibition of many financial products commonly found in the West and on the other hand in the appearance of a wide range of specific products. It should be underlined that the Islamic economic theory is not uniform. There are several theories for many economic issues, which may even be contradictory. In addition, their actual implementation within the country creates other specifics. It is a tax for its relatively short existence, which dates back to approximately the Second World War.

The basic building block of Islamic economics and finance is Mudarabah. In its theoretical form it is a *manifestation* of the principle of sharing risks and losses. It is often mistakenly referred to as a banking product, which does not fully capture its character. Its role is on several levels. Islamic banks present it as a product offered to the customers. In fact, it further regulates the relationship between the bank and the depositor (Hrdličková, 2012a), and the principles upon which Mudarabah builds are also considered by the Islamic economic theorists as a fundamental pillar of an economy compliant with Islam.

Mudarabah is generally defined as a partnership between human and financial capital: *The term refers to a form of business contract in which one party brings capital and the other personal effort* (Institute of Islamic Banking and Insurance website, undated). *The central idea in the concept of Mudarabah is that two parties, one with capital and the other with know-how, get together to carry out a project* (Gafoor, 2001). Mudarabah is therefore based on an agreement between one or more investors (i.e. the owners of capital; in Arabic such a person is referred to as a *rab al maal*) and an agent (in Arabic *mudárib*).[14] The agent acts as a manager who manages the funds entrusted. Upon the termination of this partnership, the

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[12] See *Nedorozumění ohledně pojmů halál a zebíha a praktická řešení problematiky halál masa*. E-Islam. Accessed on 20 April 2014. Available at: <http://1url.cz/7a4I>.

[13] *Prohibited to you are dead animals, blood, the flesh of swine, and that which has been dedicated to other than Allah, and those animals killed by strangling or by a violent blow or by a head-long fall or by the goring of horns, and those from which a wild animal has eaten, except what you slaughter, and those which are sacrificed on stone altars …* (Quran, 5:3). *And do not approach unlawful sexual intercourse. Indeed, it is ever an immorality and is evil as a way* (Quran, 17:32).

[14] If Mudarabah regulates the relationship between a depositor and a bank, the depositor acts as an investor and the bank acts as an agent managing the funds entrusted. On the contrary, if Mudarabah serves as a tool for financing, the bank acts as an investor and a person coming with a business plan as an agent.

agent is entitled to reimbursement of the costs he invested and to a profit. The investor in turn receives the rest, that is, the principal and interest from the revenue.

The roots of Mudarabah can be traced to the pre-Islamic period. In the 1950s, when the voices calling for an economy governed by Islamic principles began to increase in Islamic countries, the need to submit a new economic theory satisfying such requirements arose. Such a concept was presented by Muhammad Nejatullah Siddigi (Siddigi, 1983). He built the theory on the principle of profit sharing, and he was inspired by the principle of Mudarabah in its development. The economy, in his interpretation, can be described as *Mudarabah in large* (Weberová Babulíková, 2001). A fundamental mechanism of such an economy is the establishment of the funds managed by banks, in which each depositor will save his/her money. The banks then further invest the money. Mudarabah in this concept can be compared with collective investment. It is obvious that it would be impractical, considering the high transaction costs, to monitor the rate of return of each Mudarabah. Instead, the deposits *are merged* with the funds. The deposits are consequently invested and the revenue is divided proportionally among the investors while the bank charges the costs invested and a share of the revenue from this profit. The cost of capital will not be the interest, but a probable rate of return.

Mudarabah is also presented at the theoretical level by Islamic scholars as the main product of Islamic banks. It is intended for long-term financing. Muhammad Sadr perceived it as essential to create such an environment in which Mudarabah is considered a standard, not an exception. Muhammad Siddigi completely identified himself with Sadr’s view when he claimed that a system based on profit sharing should always be preferred to methods based on the additional charge method (Weberová Babulíková, 2001).

Another financial product based on the principle of sharing profit and loss, in addition to Mudarabah, is Musharaka. It is a partnership of two and more people who combine capital and labour in a joint venture and the results of this partnership in the form of profits are divided according to a predetermined ratio, while the loss is shared according to the share (Rammal, 2004). In the case of Musharaka, compared with Mudarabah, all the partners have the right, but not the obligation, to participate directly in the management of the project.

The principles of Islamic financial law emphasize that profit is justifiable as a reward for the risk taken or the work carried out. This principle determines the form of deposits in Islamic banks. Islamic banking works with two types of accounts – current and investment. In the case of a current account, a customer bears no risk and therefore is not entitled to any profit in any form. The deposited funds are managed under the type of contract called wadia.[15] Investment accounts are then increased in value in accordance with the principle of sharing of profits and losses.

The legislation on bank deposits comes under the scrutiny of Islamic scholars, especially when considering the operation of Islamic banks in the European regulatory framework. The principles of Islamic finance allow a profit only under the assumption of undertaking the risk of loss. Current accounts in the Islamic concept thus do not generate any profit. Profit can only be granted for investment accounts, for which, however, the rate of return cannot be guaranteed beforehand. The rate of return is derived only on the basis of the real success of banks in the allocation of resources, while if there is a loss it is debited from the deposits in investment accounts. This philosophy is problematic in many European countries. Trakic (2012) notes, for example, that Islamic banks cannot be regarded as a *bank* in the Italian legal framework, because it works in a different way: it does not collect deposits from the public with a guaranteed rate of return and consequently does not provide loans, which are currently two essential conditions that define the Italian legal environment of the bank. Somewhat more favourable to Islamic banking is the legislation of the UK, which is among others related to the Anglo-Saxon system of law used there. Islamic lawyer Aldohni (2012) identifies three main conditions that define a bank in the English legislative framework – (1) receiving repayable funds from the public, (2) offering current accounts and (3) issuing cheques and processing transactions. Analysing the requirements imposed by Islamic law, he reaches, in terms of the functioning of Islamic banks in the light of the above conditions, a positive conclusion, stating: *The practise shows that Islamic banks have all the main characteristics of the banking business – offering current accounts, checks and transactions, including overdraft options. In other words, they have all the characteristics required by the British case law ...* (Aldohni, 2012).

Deposits are insured in the European Union against a loss of up to 100,000 EUR.[16] The definition

[15] Wadiah means a depository. It is an authorization to the third party for safekeeping of the depositor’s assets. As a rule, the third person is not allowed to use the deposit while at the depository (Potměšil, 2012).

[16] Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay.

of a deposit in the Czech Republic is to be found in the Czech Banking Act, in which it is understood as entrusted funds, which constitute an obligation of the depositor for the payment.[17] In the case of deposits, any sharing of losses is thus impossible. A form of revenue sharing is also an issue, because the revenues in the Islamic environment cannot be predetermined at a fixed rate. However, the domestic legislation is in this sense nonconformist. The revenue from the current account cannot be continuously adapted to the current success rate of the bank.[18] On the other hand, domestic regulation enables banks to offer clients current accounts with no use of interest. Even though the law states that *...the payment service provider is liable to pay the service user (the account holder) the agreed interest from the balance on the current account* (Štenglová et al., 2010), the obligation to negotiate such interest in its text is not mentioned. Thus, due to the nature of commercial law, when the principle of *what is not forbidden is allowed*, it is possible to avoid the use of interest.[19]

In the Islamic environment, the actual insurance also has a specific position. That is prohibited in its conventional form. The reason is the prohibition of gambling (the maisir principle). The classic insurance relationship is characterized as the insured as a buyer pays a periodic premium as the price, but depending on chance may or may not receive the object of sale (Maitah, 2010). Alternatively, insurance prohibition is explained by Kohout (2005) as follows: *It is a generalization of the prohibition of interest, as the interest is seen as a guaranteed return, and it also concerns the fact that one cannot oppose the will of Allah – that is to insure oneself against ill fortune.* Islamic scholars have had to come up with an alternative insurance principle that would be in agreement with the principle of maisir. This Islamic alternative is called *takaful*. It is based on an often-mentioned call for solidarity in the Quran. The risk in such an insurance system is not sold, but shared. Individuals contribute to a fund that is in their ownership. In the event of a claim, the damage is absorbed on the basis of mutual assistance.[20]

Islamic financial institutions are often accused of money laundering activities. It should be emphasized, however, that such action is contrary to Islam. The source of support is particularly the Quran verse 2:188: *And do not consume one another's wealth unjustly or send it to the rulers in order that you consume a portion of the wealth of the people in sin, while you know!* Zulkifli (2006) explains that the word *fraudulent* refers to all property acquired by illegal means, such as theft, fraud, smuggling, etc. Since Islam despises wealth thus obtained, money laundering is contrary to Islam itself. From the verse of the Quran 3:104, which reads *And let there be from you a nation inviting to good, enjoining what is right and forbidding what is wrong* ..., it can then be deduced that both individuals and private and public institutions have the obligation to build a healthy Muslim society. A corollary is that the Islamic financial institutions have a duty to take preventive measures to fight money laundering, as they are in direct conflict with the teachings of Islam (Zulkifli, 2006). Islamic financial institutions are thus under dual control – controlled by the state where they work and by the Islamic Supervisory Board, which oversees compliance with Islam. Nevertheless, as stated by Hassan and Lewis (2007), after 11 September 2001, a tendency appeared to confuse the Islamic financial institution funds with financing Islamic terrorism. That is misleading by itself. In the words of Hrdličková (2013), *...financial institutions with business that is founded on the principles of ethical financing, such as the principles of Islamic finance law, and which carry out their activities in accordance with these principles, cannot be evaluated without further suspicion due to the increasing risk in relation to such activities, such as money laundering or financing terrorism.*

In relation to the further text, it is useful to mention along with Mudarabah another banking product, namely Murabaha. This is often referred to as a *costs plus surcharge*. Murabaha is not based on the principle of sharing profits and losses, which makes it somewhat controversial. It is a tripartite contractual relationship between the seller, the client and the bank. The client will ask the bank to acquire certain assets from a third party, precisely specified in the

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[17] The provision of § 1, paragraph 2 of Act No. 21/1992 Coll., on banks, the current version.

[18] The change of the return in deposit accounts is addressed in § 94, paragraph 5 of the Act No. 284/2009 Coll., the Payment System Act, the current version, in which a unilateral change in interest rates is possible, but only as a result of changes in referenced rates. It is not possible to change interest based on other factors. Due to the inability to share profits and losses, a potential Islamic bank would not be able to accept deposits only for *custody* (i.e. the same as in current accounts' wadia). However, domestic banks may also offer investment accounts through affiliated investment companies, because the principle of sharing profits and losses is possible in the collective investment. It seems, therefore, that any Islamic bank in the Czech Republic would be able to carry out the main focus of its activities.

[19] The authors are inclined positively towards the question of the possible existence of Islamic banks in the Czech Republic.

[20] For more about Islamic insurance, see for example Khorshid, A. (2004). *Islamic Insurance: A Modern Approach to Islamic Banking*. London: RouteledgeCurzon.

contract, which the client purchases from the bank. The actual purchase of an asset at a predetermined price is usually associated with a deferral. The bank's profit in the form of a surcharge is justified as remuneration for the work and risk-taking.

In Islamic economics, just as in its conventional counterpart, the central bank has a crucial role in regulation and supervision. On one hand, it must protect the interests of its depositors, especially smaller ones. It was Siddigi (1983) who emphasized that the basis of such efforts is proper investment diversification and a safe ratio between basic capital and deposits. The ultimate objective of monetary policy is identical. While the Czech constitution speaks of *price stability*, in Iran, for example, the main objective is defined as *preservation of the value of the national currency.* However, the special traits of Islamic economics determine that the local central bank must achieve its main goals differently. The special traits of the Islamic monetary policy can be seen in two areas. First, the instruments of monetary policy cannot use an interest rate in any form and must also choose a different transmission mechanism.[21] The second area is comprised of the instruments of monetary policy. Islamic economists are clearly aware of the importance of interest rates in the regulation of the amount of money in the economy. It was therefore necessary to respond to the demands of Islam and construct alternative instruments, which the central bank would use to replace the role of interest in monetary policy. The philosophy of the principle of sharing profits and losses, which uses the profitability of the project for the allocation, was used as a base for its construction. The central bank can act as a lender of required liquidity for a commercial bank. The charge for this service is the weighted average rate of return prevailing in the state economy. The weight is given by the importance of individual sectors in the economy. Unlike interest, this would not be a fixed fee. On the contrary, it would be dependent on the real profitability of the financial capital, which is the core argument on which the presumption of the compliance of the described instrument with Islamic law is based. Thus, an instrument constructed in this way would naturally correct an economy towards zero inflation. In times of a growing economy, when the profitability in the economy is high, the lending fee would also be high, which would subsequently reduce the aggregate expenses as well as the pressures of inflation. On the contrary, in times of recession, when the profitability in the economy is negative, the lending fee would also be negative (a bank would be required to repay less than it borrowed), which would subsequently prevent deflation (which is often considered from a macroeconomic point of view to be more damaging than inflation) through an increase in the aggregate demand. The Islamic central bank could at its discretion debit the weighted rate of return with a plus or minus surcharge that would enable it to enter and affect the aggregate demand and thus inflation actively (Zangeneh and Salam, 1993). The Islamic central bank may carry out trades on the free market with the same intention as a conventional bank, but not using conventional financial instruments such as treasury bills or bonds. However, there are viable alternatives – noteworthy in particular are the Islamic bonds, alternatively called sukuk.

Sukuk represents participation in a particular underlying asset from which its profitability is derived: *The benefit of owning an underlying asset is transferred to the holder of a sukuk certificate along with its entire revenue but also with the risk of potential loss* (Schoon et al., 2009). The real construction of sukuk itself is similar to the process of securitization used on conventional markets – given pooled assets, the bonds are emitted. The profitability is derived from cash flow that is generated by the underlying assets. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines sukuk as: … certificates proving a shared co-ownership on the ownership of tangible assets, right of use and services or assets of particular projects or special investment assets. Sukuk, as opposed to a conventional bond, is not a long-term debt security but a document confirming co-ownership of the asset defined.

4.1 Islamic banking

Islamic banking, also commonly referred to as *interest-free* banking, has earned the attention of the Western world due to its turbulent growth in recent years. The key feature of Islamic banks is developing banking activities in accordance with the principles of Sharia. According to Khan (2010), it is preferable to use the term *Sharia-compliant finance* instead of the term *Islamic banking*. Both Muslim and non-Muslim clients may use the services of such institutions. According to El Hawary et al. (2007), Islamic banking or rather finance is characterized by four attributes: (1) symmetrical sharing of risk and profit, (2) the financial transactions must be either directly or indirectly linked to real economic transactions, (3) non-exploitation of any contracting party and (4) a prohibi-

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[21] Currently, the most common transmission mechanism is inflation targeting, which is also applied by the Czech National Bank. Here it is also used as the interest rate channel, which may not be used in the case of the Islamic central bank. It must use an alternative transmission channel, for example, the bank-lending channel, the efficiency of which has been studied in Malaysia. See Zamrah and Majid (2011).

tion on funding activities that are sinful from the perspective of Islam (such as alcohol). Islamic banks perform the same function as conventional banks, namely as payment service providers and financial intermediaries. There are three basic models, under which they carry out their activity – the two-tier mudarabah, two-windows and wakala models. Islamic banking is, however, also subject to criticism. For example, Kuran (2005) states that Islamic banking was not designed as a viable alternative to conventional banking, but mainly to strengthen the Islamic identity. He illustrates this statement by the fact that, in practice, Islamic banks behave similarly to conventional banks, despite their moral principles.

5. System of sharing the risks and losses in practice

Although Islamic economic theory sees its main basis in the sharing of risks and losses, a number of complications are associated with this principle in banking practice. Islamic economists cannot have missed this fact either. Ahmed (2010) identifies three main categories of issues:

- Problematic funding of long-term and low-return projects
- Problematic funding of small businesses
- Problematic money lending to an already operating business enterprise

From the perspective of assessment procedures, negotiations with the given business enterprise and the requirements regarding the expertise and experience, a system based on sharing profits and losses is much more expensive than conventional (interest-based) loans. The reason is the participation in the profit. The bank must investigate in much greater detail the profitability of the business enterprise, the chance of success of the given project or the prerequisites of the business enterprise to implement the project successfully. This is all in addition to and with regard to the anticipated future development of not only the business unit itself, but also the entire industry. All the variables that the bank must consider before granting such a product are then subject to uncertainty, which increases in direct proportion to its duration. This is why banks avoid funding long-term projects. Another reason that speaks against long-term funding is a characteristic feature of the product based on the sharing of profits and losses. With the traditional Mudarabah and Musharakah, the invested amount and any potential share of the profit is paid on the termination of the relationship between an investor and an agent. Unlike a standard loan, there are no regular repayments. Products based on the sharing of profits and losses tie down all the invested capital throughout their duration. Due to this fact, compared with conventional banks, Islamic banks are very limited in the payment of money deposits.

The issues outlined in the paragraph above are even more visible when it comes to the finance of small businesses. A bank is not able to analyse responsibly the expected profitability of each small-business project at sustainable costs. Raquib and Ahmed note the results: *Many of these small producers, who traditionally were able to obtain interest-based credit facilities on the basis of collateral, are now finding it difficult to raise funds for their operations* (Ahmed, 2010).

A functioning company often needs a fast liquidity supply to be able to satisfy unexpected needs. Mudarabah and Musharakh are primarily intended for financing completed projects. In the case of small loans, which an entrepreneur often needs only for a solution to a partial issue, it is difficult, if not impossible, to calculate the profit that this capital actually *generated*. The use of products based on the sharing of profits and losses is in such cases impossible in practice.

Even the efforts to implement the principle of sharing profits and losses in financial instruments are facing difficulties. It is worth paying particular attention to the difficulties in connection with Islamic bonds. In the past, for emissions of these bonds, an effort has been recorded to establish their profitability on the referential interest rate. This, however, was sharply attacked by the legal community, which argued particularly the need to derive profitability from the underlying real assets. Establishing the bond profitability of LIBOR rates, bonds torn off from reality and thus these bonds become identical to the conventional alternatives (Al-Amine, 2008). In 2008, new standards were issued by AAOIFI,[22] which tightened the requirements for bonds based on sharing the profit and loss. The response of the markets was a further reduction of interest for these bonds (Azmat et al., 2013). Although the use of the referential rate is inadmissible from the viewpoint of Islamic law, it would be a solution to the essential problem of the bond structure – the lack of transparency in markets in which Islamic bonds are generally allocated and the resulting information asymmetry. However, due to the increased risk (the principal is not guaranteed either) of these bonds, the requirement for an information base is essential. Knowledge from the real behaviour of issuers has

[22] The Accounting and Auditing Organization for Islamic Financial Institutions – the organization issues generally recognized standards, which play an important role in the gradual harmonization of Islamic finance. Compliance with the rules of AAOIFI is voluntary and unenforceable, but its standards are reflected in practice.

shown that companies that are expecting low profitability of their projects or that are experiencing a higher risk of possible loss tend to share the profit and loss through bonds. In the case of the opposite anticipation, they resort to bonds carrying a fixed income for their holders (Godlewski et al., 2013).

6. Islamic law and its circumvention

With the renaissance of Islam, customers' demand for products that would be in accordance with Islamic law has also emerged in other countries that are not solely populated by a Muslim majority. Islamic banking has a huge potential in Europe, among others, especially in the context of demographic forecasts of the growth of the Muslim population. However, in terms of economic results, Islamic banks have a more difficult starting position due to the requirements imposed by Islamic financial law, which makes them less competitive from the perspective of financial ratios.[23] The lower profitability (in 2012 the ROE indicator averaged 10% for Islamic banks, while for conventional banks it was 13%) is mainly caused by higher operating costs, which are the result of the characteristic method by which Islamic banks operate. Compared with conventional banks, the costs associated with bank employees are higher. In 2010, Islamic banks spent 60% of their total operating costs on their employees, while conventional banks spent 54% (Nazim and Ibrahim, 2012).

The economic results of Islamic financial institutions are burdened by the restraints of Islamic financial law as well as the management of financial capital. Islamic financial institutions may only invest in instruments that comply with Islamic law and the conventional instruments usually (though not flat rate) do not. In this context, the Central Bank of Malaysia and Securities Commission Malaysia refer in their annual report (2009) to the so-called *captive investor*. Due to the sustained growth of Islamic finance, the demand for all acceptable investment opportunities is growing and, as a result, there is currently excess demand for Islamic products over their offer. This fact is reflected – among other things – in the lower performance of Islamic investment companies associated with a poorer ability to diversify their portfolio (Al-Khazali et al., 2013). This situation has consequences for example for the Islamic bonds – empirical studies suggest that there are different reactions of stock markets to the issuance of Islamic bonds of private companies in comparison with the response to the issuance of conventional bonds. The reasons for this are companies moving to the markets of Islamic bonds, knowing that financing through the conventional market is no longer available to them. On the contrary, the Islamic markets perceive these companies as an affordable way to gain their funding, with the knowledge of the excess demand for financial instruments. Stock markets predict such behaviour and view the issuance of Islamic bonds as signalling the potential problems of the business. As a result, their negative reaction is characterized by a reduction in the share price, while in the case of the issuance of conventional bonds, the market responds insignificantly (Godlewski et al., 2013). Islamic financial institutions are also limited in terms of dealing with excess cash. Instruments such as treasury bills and repo operations are banned by Islamic banks due to the fact that they bear interest (the principle of the prohibition of riba). Although Islamic finance was created regarding the management of liquidity with free alternatives, those are still the subjects of controversy. These tools are either less profitable[24] compared with conventional tools (modified Mudarabah) or are rejected by some Muslim lawyers (securities and stocks based on bai' dayn).

Islamic financial institutions are facing the obvious fact that the principles of Islamic financial law deviate from economic effectiveness in many elements. This creates a tension between the objectively existing economic ties, to which practice tends to incline, and the ideals of Islam. In order to preserve the authenticity of Islamic banking, effective regulation and supervision by an independent authority are required. Currently, financial regulation in Iran, Sudan and Pakistan is fully Islamized, and compliance is supervised by the state. Without the implementation of Islamic financial law in a state's legislation, a bank's compliance with Islamic principles is verified by a group of Islamic lawyers organized in committees. They are basically employees of the bank. The consent of the given committee in the eyes of Muslims declares that the

[23] Islamic banks, however, have a competitive advantage in selected characteristics. For example, the clients of Islamic banks hold a larger percentage of their deposits in their current accounts than is the case with conventional banks. Given that Islamic banks offer their current accounts interest free, the deposits are cheaper overall for the Islamic bank. In addition, the focus on retail clients allows Islamic banks to achieve higher margins (Nazim and Ibrahim, 2012).

[24] The lower profitability results from the restrictions of Islamic financial law. The fundamental philosophy of Islamic finance is that money cannot generate itself. The profit is justifiable only if it was achieved through work. In other words, free liquidity must ultimately be invested in the real economy and in areas that are not *haram* (such as gambling, pork, alcohol, etc.). Difficulties in merging operations and the demand for real investment overnight are obvious. The presented solutions are thus inevitably on the edge of acceptability to Islamic law. See Wilson (2007).

given financial product is *halal*, that is, admissible from the perspective of compliance with Islam. The actual agreement takes the form of a *fatwa*. However, a fatwa itself is not binding law, and its publication does not necessarily guarantee compliance with Islamic law. It is therefore clear that there is relatively large room for the individual opinions of the scholars.[25] It is a price paid for the rapid development of Islamic banking in recent years, which prevented the establishment of a central authority supervising the compliance with the provisions by the Islamic banks. It can be concluded that the lack of standardization of Islamic banking creates room for deviation of individual banks from Islamic law in favour of purely economic goals.

The current practice is clearly marked by the effort to catch up with conventional banking in the key economic indicators, although it violates the principles of Islamic finance. This can be clearly demonstrated by several examples. Murabaha is the most significant case. It is an agreement whereby the bank purchases a prearranged item for the customer from a seller and subsequently sells it to the customer, but at a higher price. Therefore, the product, due to this characteristic feature, is often called *costs plus additional fee*. An increase includes the costs incurred by the bank and a predetermined profit. The customer's payment is deferred and is specified in the agreement. The goods remain the property of the bank until the customer pays for them.

Islamic lawyers pay close attention to the differentiation of a *fee* from *interest*. Lewis (2001) points out that making a profit is associated with the work to obtain the goods from a third party, so it is not just an exchange of money for other money across time. In addition, when implementing Murabaha, each bank assumes the risk lasting from the time of the purchase of the goods from the seller until its subsequent sale to the customer. The argument is also on the different character of an additional fee, which is in no way dependent on the duration of the agreement, but is charged for the service as evidenced by the absence of penalties for late payments, as it is common for interest (Hassan and Lewis, 2007).

However, in banking practice, the bank, while preparing the agreement, names the customer to become the bank's agent, who is subsequently instructed to accept the goods, negotiate with the seller and inspect the goods. At the same time, it delegates all relationships with insurance companies and other governmental and non-governmental organizations to him/her. Defending an additional fee along with pointing out the efforts of the bank seem to be in conflict with the fact that the bank elegantly delegates all the responsibilities to the customer. The bank also significantly reduces the risk carried. The customer becomes fully responsible for the goods immediately upon receipt. Given that the customer acts simultaneously as an agent authorized to accept the goods from the seller, the bank does not come into contact with the goods at all. In addition, Islamic committees accepted the collection of penalties for late payments, which was justified by the needs of practice. If the Islamic banks were not allowed to use such a method, it would be in the field of moral hazard. Insolvent customers would not pay and the purchased goods would remain in the ownership of the bank. For this reason, the application of sanctions against non-payers was allowed by the Islamic committees. The argument that the level of an additional fee is not dependent on the duration of maturity has proven to be invalid in practice. For example, the Kuwait Finance House, for a 10-month-long Murabaha, requires an additional fee of 2.29%, for 20 months it is already 4.58% and for 180 months it is 54.5% (Kuwait Finance House, undated).

A fixed, predetermined fee for late payment is basically interest under a different name. Any profit made without one's own efforts or risk-taking according to Islam is illegal, regardless of how well hidden it is. In other words, this operation is in substantial contrast to the fundamentals of Islamic law, in particular the prohibition of riba. The argument that riba is associated with a loan while Murabaha is associated with a sale does not stand up due to the denial of the spirit of Islamic law. This is the spirit that was so emphasized in the extension of the interpretation of riba, besides usury, to interest. The Murabaha issue is further accentuated by the fact that it is a dominant product of Islamic banking, without which the existence of Islamic banking would be unthinkable – Weberová Babulíková (2001) states that in the 1980s Murabaha accounted for more than 80% of the total volume of financial transactions. In a later work, Maitah (2010) adds that even after almost thirty years, the reality has not significantly changed and Murabaha still accounts for approximately 75% of the volume of transactions. The efforts of Islamic lawyers for the defence are thus so understandable because experience clearly shows

[25] Khan (2010) reported that worldwide there are only 20 universally accepted Islamic scholars. Each of them is on average a member of 40 to 50 Islamic Supervisory Boards, while the annual fee for membership of one such board is between 20 000 and 30 000 dollars. Concurrently, an Islamic scholar can earn by certification of significant transactions one-off fees of 150 000 up to 500 000 dollars and it is often only for the transfer of conventional financial terms to the terminology of Islamic jurisprudence. It is thus clear that the scholars sitting on the boards have a clear conflict of interest. The only state that has reflected this so far is Malaysia. It established that a scholar may be a member of only one Supervisory Board.

that banking services cannot be based solely on the principle of sharing profits and losses. However, the contradiction between Murabaha and Islamic law is obvious. Its conscious denial by the Muslim legal community only underlines the inability to enforce the principles that are incompatible with fundamental economic laws.

In contrast to the dominance of Murabaha, the marginal importance of Mudarabah is noteworthy, which according to Sadr and Siddigi's visions was supposed to become the principal long-term product of Islamic banking. The reason for its marginal importance has already been outlined in the discussion of the issue associated with sharing risks and losses – both Mudarabah and Musharakah work on this principle. However, attention should also be paid to the efforts of Islamic banks to bridge the problematic aspects of Mudarabah. While trying to *sandpaper* those objective economic deficiencies, the banks often go beyond the edge of Islamic law. This can be demonstrated by the contractual subtype of Mudarabah – the Mudarabah with a promise of sale (Kahf, undated). It deviates from the generally characterized Mudarabah in a fundamental premise. In this type of Mudarabah, it is not just a rab-bal-mal (investor) who deposits the funds but also an agent (bank customer). The ratio at which the initial funds are deposited is fixed. The investor provides 90% and the agent provides the rest. The subject of this type of Mudarabah is, above all, to use deposited funds for the construction of movable or immovable property that is subsequently sold. A method of returning the funds to the bank is particularly controversial. In the standard Mudarabah, the customer is the one who manages and returns the funds, including the profit share at the end of an agreement. In this subtype, the return of the funds is ensured by an obligation of the customer to purchase a 90% share in the project from the bank, while the price of this share is determined in the agreement in advance. The bank thus sets a certain rate of return, which is not directly proportional to the success/failure of the specific project.

Taking into account violations of Islamic financial law by financial institutions that are tolerated, the dogmatic approach to similar behaviour on the side of the Muslim population is remarkable. An Islamic scholar, Qu' ood, dealt with a case in which an unspecified Muslim owned a share of the company that purchased shares of a bank that worked with interest 25 years ago. The company, however, ran into problems and the relevant portion of the shares was transferred to this Muslim. The value of the bank's shares, meanwhile, increased from 1,000, for which it was purchased, to 30,000 Saudi riyals. The owner wanted to sell the shares and retain the return. However, the Islamic scholar concluded that such an approach would be anti-Islamic. In accordance with Islamic law, only the retention of his assets is allowed, which is the original 1,000 Saudi riyals. The rest was to be donated to charity, as it had been achieved in a conflict with the prohibition of riba (Qu´ood Ibn, undated). In another fatwa, Usmani addresses the question of a Muslim inquirer who would like to lend the money to his friend's business while the friend would pay him a preset amount as a profit share. Usmani identified such a loan as non-Islamic because the creditor would be the only one burdened by the risk from the business activity (Usmani, undated).

7. Conclusion

Islam, or Islamic law, is characterized by the efforts to control the individual's life in all its complexity so that it is aligned with the will of God. That ideal is eternally imprinted in the primary Islamic law, which is unchangeable. The flexibility of Islamic law is therefore only to be achieved through the interpretation of the primary sources of Islam. Islamic economists were thus confronted with a difficult task: to design an economic system that would reconcile Islam with economic reality.

Islam itself is distinctively tied to a strong desire for a just society. This feature has triggered a major discussion on the prohibition of riba, during which interest was placed under this term. When arguing about its prohibition, issues of morality were accentuated, rather than economic needs. Islamic scholars have tried to replace it with the principle of sharing the risks and losses. The cost of capital was supposed to become a probable rate of return on the capital.

When analysing the products of the current Islamic banks, there is a tendency to move away from the principles of Islamic law, when an even deeper gap arises between these principles and the practice. It is therefore possible to provide a clear answer to the question asked in the introduction of this paper – there is a contradiction between the actual behaviour of the economy or individual businesses and the Islamic principles. On one hand, Islamic scholars criticize interest for its immorality; on the other hand, they quietly accept products that generate profit in a virtually identical manner. The direction in which practice deviates from theory is also noteworthy. There is apparent convergence of real Islamic banking and conventional banking. It is therefore necessary to agree with Maitah (2010), who states: *Islamic finance is a sector that is in many ways trying to rediscover America through a gradual approach to Western financial practices.*

In the argumentation of Islamic scholars in connection with interest, some basic economic laws have

been omitted. Islamic economics will need to reflect the inability to apply the principle of sharing profits and losses in a number of projects and openly admit the use, albeit regulated, of interest. Although interest is from an ethical point of view undoubtedly problematic, it is in many transactions more efficient than the application of more moral alternatives. It seems efficient to abandon the dogmatic attachment to particular matters and focus on maintaining the basic philosophy of Islamic banking – an emphasis on morality, ethics and humanity. Interest itself is not able to deny the essence of the ideal of Islamic finance, which cannot be said about the approach of Islamic lawyers, which is currently showing the symptoms of schizophrenia in many ways.

The conclusions of this paper cannot be interpreted as questioning the viability of Islamic banking. A renaissance of Islamic self-awareness, whereby Islam gains a dimension of Muslims searching for their identity face to face with Western civilization, will continue to assist Islamic banks in the growth of total deposits. In addition, the current Islamic banks show a lower tendency to engage in risky and speculative behaviour than Western banks (a reflection of the principles maisir and gharar). Even in this paper the criticized principle of sharing of profits and losses is suitable when applied appropriately to reduce moral hazard, with which the current Western financial system struggles. However, this article has shown the fact that the term *Islamic bank* may to a significant extent become a marketing label rather than a reflection of the real performance of such banks in accordance with Islamic principles.

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