

# BASIC CONCEPTS IN ISLAMIC BANKING

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**Abstract:** *In order to understand the concept of Islamic banking, which is conceptually and practically different from the modern banking that we encounter in the western world, it is necessary to understand the basic concepts of Islamic banking. Basic concepts have their roots in the Koran governing all aspects of Muslim life including economics. The aim of this paper is to put some light on these concepts and explain them in detail.*

**Keywords:** *Islamic banking, concepts, the concept of Islamic finance*

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## 1. INTRODUCTION

Islamic economics and banking are based on the principles of the Koran, which coordinates the economic policies of life with Islamic law. Islamic law is based on religion, on Sharia, and it establishes the general economic policies both for individuals and for the state. Sharia is a set of rules, customs, values that govern the life of a Muslim. It is based primarily on the Koran and the Sunnah (what the prophet said, did, confirmed) and includes all segments of the economy, politics, society, crime.

In this way, the finance and banking in Islam are an integral part of the religion that is in full compliance with it.

Most important for the understanding of the Islamic banking system is the understanding of the Koran, understanding the ban on charging interest. The Koran is clear on this point, it tells the believers that if they believe in Allah they should not take from the one to whom they give, or they would be punished. These words show to what extent interest a serious sin in Islam. Those who believe in Islamic school believe that this system is superior on many levels. First of all it leads to fostering investors to finance directly into entrepre-

neurial ventures. It is believed that the interest-free system allows consumption in accordance with their capacities and does not lead to increased borrowing to which lead banks lending money with interest. In contrast, many see Islamic banking as a much more humane and optimistic option than conventional banking.

## 2. BASIC CONCEPTS

The prohibition of interest as an ethical code of Islam is represented primarily in Islamic law, i.e. Sharia. Sharia translates as a stream that leads to the main river, road or right lanes.

It contains the instructions of Allah to his servants on how to live their lives through concrete examples and includes all areas of life including finances. Many texts, however, date back several centuries and are not easily applied in modern business. For this reason Sharia requires additional interpretation. It covers all aspects of life, behavior towards other people, moral, clothing. Finally, Sharia law includes laws relating to crime, divorce, international relations and all that in Western countries is solved by Laws.

At the end of the tenth century, from many various texts Muslims were able to form one unit that connects social and religious aspect, and creates a single system of law. Simply put, there is a whole set of doctrines that interpret Sharia and create a series of comments.

The Koran and Sunamets form the basis of Islamic law. Then we have the secondary sources that make up the different schools. After Muhammad's death 632 B.C. caliphs became legal interprets of Sharia law.

In this way, i.e. through different interpretations different schools have been created which today lead to a division in the Muslim world. There are five of them, but they will not be specifically addressed in this paper.

The term fatwa is very important for the understanding of Islamic law and therefore finances. Fatwa represent the opinion of participants of certain schools (Mufti) based on its understanding and interpretation of the origin of Islam, combined with his knowledge of certain topics and social contexts that are tied to a specific question. The fatwa is not binding but is a recommendation and its importance depends primarily on the integrity of the person who is giving it. As such it may, of course, be challenged.

In Islamic banking Sharia law is used in terms of what is allowed or prohibited. Sharia Supervisory Board ensures that the Islamic banking and finance follow the right path, that zakat is dully paid, that there is no gambling, for example.

Islam has always been closely associated with the trade. In the period when the Prophet arrived at Mecca it was already a highly developed trade center.

Islam as a religion seeks to encourage trade. According to Muslim belief, one should be engaged in any activity and thus provide himself with the necessities of life. Waiver of all assets and solitary monastic life is not appreciated.

However, Muslims should not allow the job to run their lives.

**Halal** is a strict rule of ethical investments relating to Islamic financial activities. This rule does not allow Islamic banks to finance certain activities that are prohibited in Islam, such as gambling, alcohol, pork and the like. According to Islam, banks should primarily fund activities that satisfy basic human needs for food, clothing, education, health, etc.

**Maysir** implies a ban on gambling and all activities related to gambling. According to Islam, gambling enables profit without any effort and therefore is prohibited in any form.

Sharia law establishes that when it comes to ethics in commutative contracts each enrichment through any form of gambling is prohibited.

**Zakat** means annual, according to the lunar calendar, taxation of certain products (cereals for example, between 5-10 percent, depending on irrigation) to help the poor and people in need. All property owners over the minimum size pay 2.5 percent of the value of its assets, and traders another 2.5 percent in sales tax.

This tax is used to encourage conversion to Islam, the state redemption of Muslims from slavery, to help the over-indebted, assistance and accommodation of unexpected passengers, to help those who have dedicated their lives to God, to help the poor and the disabled, for the construction of general hospitals and for many other purposes. This fee is calculated individually, i.e. no one collects this tax on behalf of the state or the church because they do not have the tax department. It is either placed directly, at the discretion of the one who gives, or is released to the mosque, or giving to charity for further proceedings. Zakat is, out of the five pillars of faith, considered the third pillar of Islam. Recently, Pakistan, Saudi Arabia and Sudan proclaimed zakat to be official law, while in a number of Islamic countries it is collected by the “national banks.”[1]

According to the Koran, God has all the wealth, the private property is considered a gift from God. Assets have a social function in Islam and must be used for the benefit of society. It is believed that social justice is the result of organization of Islamic society, including internal and employment and creating equal opportunities for all in order to seize their own opportunities and thereby earn enough to live. Justice and equality in Islam means that everyone has equal opportunity, not equal to the poverty or wealth. Islamic country should allow for a minimum of existence for all its inhabitants.

The mechanism of distribution of income and wealth is one of the foundations of Islam so that every Muslim is guaranteed a certain standard of living. Zakat is the most important instrument of wealth distribution.

**Gharar** means sale of possible objects whose existence or characteristics are not guaranteed because of their nature, which makes it similar to the gambling sale. In the Sharia there are numerous concrete examples such as the sale of sea fish, runaway or unborn animals. None of these things is certain. We can not sell fish that was not caught, etc. It is therefore in the best interest of both parties for the contract to define what is sold and at what price. Thus, for example, it is forbidden for a person to pay in advance anything that a game hunter might catch. But if someone did pay a certain price to the hunter for a certain period of time, he gets everything a hunter catches.

Gharar means entering a particular business without sufficient facts or undertaking of some risky transactions that could affect a whole series of transactions. It includes:

- transactions in which the seller is not able to hand over the goods to the buyer
- transactions where the object of sale can not be determined
- speculative transactions such as trade in financial derivatives
- transactions where the customer is not able to verify the quality of the products they purchased.

Some transactions are, however, possible i.e. minimum uncertainty is allowed but only in situations when certain conditions are met, namely:

- when services and products are existing for sure
- when the characteristics of the products and services are evident
- When both parties have such natural control of agreement that can enable the transaction to happen

- when the date of the transaction is predetermined

It is forbidden to enter into financial insurance contracts where certain fixed sum to be paid every month and thus one of the parties - the insured - may benefit if the insured event occurs after a single rate. Or it may be a company to pay if you never come. Other important agreements that are prohibited by Islamic banking are forwards, futures, options and other derivatives. Forwards and futures involve gharar as building sales may not exist at the time when the contract is executed. There are certain forms of contracts that are allowed but they will especially be processed in this paper.

The attitude of the science of law to gharar was best defined by Sheikh Dhareer in 1997:

... Gharar in future contracts is the possibility of loss to get one of the parties. If someone buys something with a certain contract and its conditions change or the market changes so that price falls in the moment of execution of the contract, he will certainly be obliged to fulfill and he'll regret he entered into the contract.

Indeed, the object of the contract can be changed and the contracting parties can discuss it.

According to this we can say that gharar filtered objections from the point of uncertainty that arise over time. These uncertainties are not known when concluding the contract, the parties can not know whether it will have an interest in its realization when it comes to implementation." [2]

### 3. RIBA AND DIFFERENT INTERPRETATIONS

Riba is a ban on charging interest on borrowed money. To understand the importance of Islamic banking is to understand how a riba and how it can be avoided. According to the Sharia, modern money is categorized as good, which includes riba, and include gold, silver, wheat and salt. Muslims also reject the European securities market and prohibit believers to buy and sell preferred shares, explaining his decision the fact that this action taken in advance a fixed dividend regardless of the fate of a joint stock company and other shareholders.

Believers are not allowed to buy no ordinary shares if they can not acquire control package and on the basis of voting supremacy transform Europe into an Islamic Corporation partner institution. Believers cannot buy shares of conventional corporations if it is credited by the Euro-American banks, as these are included in the interest rate regime.

Believers are not allowed to even purchase shares of companies engaged in the production and trade of products that are prohibited in Islam, such as tobacco, alcohol, pork - but also the shares of companies that produce electronic media tapes and discs that entertain audiences as in Las Vegas (the official term of Islamic theologians) and are engaged in Las Vegas type of services - hotels, casinos, lewd performances. However, Islam permits trade of ordinary shares and capital gains because it reduces to the classical purchase and sale of goods, while dividends are not fixed in advance, are uncertain and involve risks equal to all the owners of the joint stock company. This will be further discussed.

Unlike the first two rules of Zakat and gharar that exist in other religious teachings too, the third rule, the riba, is the original religious Order of the Koran. Of course, the mere thought of the unacceptability of interest is not original, because Aristotle, well known to the Arabs, condemned interest on money borrowed. In Europe this was done St. Thomas Aquinas in the thirteenth century, echoing Aristotle, but he was quickly attacked by his Dominicans in the XV and XVI century, and the Jesuits who at the universities of Salamanca,

the Spanish and the Portuguese Coimbra even justified interest and cancelled the difference between interest and usury. In Islam, this has not happened to this day.<sup>1</sup>

The basic principle in Islamic law is prohibited and is considered unjustified enrichment to receive something without adequate counter-favor. The word *riba* in translation means an increase, growth supplement. *Koren r-b-w* from which stems the origin of the word *riba* has the following meaning in the Koran: growth, increase, be large. In short, this word means growth either in qualitative or quantitative terms. In the Islamic world until today there remains a debate on what is actually the meaning of the *riba* since the Prophet died before he gave a detailed interpretation.

Islamic banking is based on the fact that profit is not *riba*. This conclusion was arrived at by analyzing the words of *riba* where the root *rab-a* mean increase, while *ribi.ha* means profit. Therefore the *riba* does not include profit. The concept of *riba* is not solely related to interest. In Islam we recognize two basic forms of *riba*: *riba al-quarud* and *riba al-buyu*. The first relates to the benefit related to the granting of loans and the other to the benefit of the trade.

*Riba al-buyu* is present in two types:

*Riba al-Fadl* involves the exchange of goods of uneven quality and quantity simultaneously.

*Riba al-Nisa* involves the exchange of goods of the same quality or quantity but not simultaneously.

Both types of fish are prohibited, the exchange of goods of varying quality and quantity, as well as delayed execution.

*Riba al-quaru* prohibits making a profit i.e. prohibits realization of interest on borrowed funds. Sometimes it can be regarded as *riba al-nasia*, i.e. as increase in interest rates over time. According to Islam, each increasing amount of borrowed funds due to the passage of time is prohibited, as well as the interest rates on all types of loans and debts. Precisely on this principle, i.e. on the principle of exchange of money of different values the entire Western banking is based.

Banks are intermediaries that lend money to the party to which it is necessary and that he returns it with interest. This is the biggest fundamental difference between the Western and Islamic banking concept.

In addition to pretty clear provisions of the Koran, as mentioned above, as well as other sources of Islam that are of importance immediately after the Koran, there are some schools of Islam that question the ban on *roba* in the Koran. There is also the question as to what extent these provisions are actually respected today.

One of the most famous works and opinions on this was given by Fazlur Rahman in 1964 who wrote about why the Koran categorically forbids both the *riba* and the function of interest rates in the banking system.

Rahman's view is that the *riba* does not stem directly from the Koran and from the prophets, but from the definition of *riba* that has been made by previous generations. Therefore, he believes that each situation must be considered individually and depending on the context.

There was much discussion about whether the interest rate applies only to the interest rate that is too large or to all types of interest. There was often a situation in which individuals were not able to pay their debt on time so that their interest in these cases was charged as double or even triple. According to Islamic belief, this is not in accordance with moral and

ethical behavior. For reasons reason, the riba has been involved in a series of social reforms that were institutionalized by the Prophet. We should also mention the way in which Islamic communities were organized at that time. People mostly lived in walled cities or as nomads. When borrowing funds, it often happened that they were not able to return them in time for reasons that were really subjective in nature, for example, due to drought and other natural disasters. Charging interest in these cases was not ethical and it clashed with the norms that existed within the communities.

On those grounds a number of opinions and attitudes was created accordint to which Islam forbids only exploitive forms of interest, and not all interest. Some have made the difference between interest on loans for production and consumption. Some advanced positions were riba only applies to individuals and not on loans between companies. The most advanced positions argue that the interest rates charged by banks are in fact a division of profits arising from the business and as such are allowed. These views, however, were never adopted. All comments and views that considered fixed interest rate forbidden, a nd variable permitted were also rejected. If we analyze variable interest rates, we find that they always consist of a fixed margin and a variable part that is made up of some reference interest rate, while fixed rates are reduced to variable rates.

The essence of interest rates is the same whether they are fixed or varied.

The most revolutionary thinking in this area was created and applied in Egypt. The first such case was recorded in 1904 during Sheikh Muhammad Abdullah who was considered it allowed to charge interest on deposits Egyptian-mail. At that point in time this was a revolutionary decision that led to a new consideration of the interest on short-term deposits. Interest earned is however used by the funds that have helped the development of entrepreneurship and thus helped the development of society itself. [3]

Starting from similar principles in 1982 The Minister of Economy of Egypt Abdel Fat-tah Ibrahim allowed the national savings certificates and savings accounts in Egyptian-mail explaining that the funds were used for investment in infrastructure, schools, mosques, etc. There are numerous references in literature that argue that the abolition of state interest due to the abolition of all types of interest rates led to a reduction in state investment projects.

The most revolutionary move was definitely a fatwa of Sheikh Mohammed Said Tan-tawi issued in 1989 in which he explained the reasons why the interest rate on deposits with the bank and the post office was permitted. At the same time he brought together a number of prominent economists to support his vision. He wanted to make a difference between the lending of money between two individuals and deposits at post offices that are part of the national savings program. He argued that the relationship between the individual and the state is the same as the relationship between a father and son because the goal is to improve the society as such. During the nineties, interest on deposits spread to certain bank deposits, arguing that it is not riba but tax to the owner of the capital and that it is completely fair considering that the investment of that money shall make a profit. He believed, moreover, that it is the duty of the state to ensure the welfare of the owners of capital so that it could continue to be invested and thus realize the benefits for the whole society. He eventually went so far that he did not see any difference between commercial and Islamic banks.

#### 4. THE REASONS WHY ISLAM PROHIBITS RIBA

Ovo je pre svega zabranjeno moralnim kodeksima u islamu. Payment of the agreed interest rates means that the one who borrows has the obligation to repay the interest regardless of whether it makes a profit or loss. This is primarily prohibited by moral codes in Islam.

Often, however, there raises the question of why someone who takes a loan would not return the interest on the borrowed funds since he is to to make a profit. The answer lies in the fact that the profit is uncertain, i.e. profits can be achieved or not, while the interest in this case is fixed.

Another reason is that it is considered that the riba slows down and hampers the development of industry and entrepreneurship. On the one hand those who earn money through the interest find it easy to come to money and are not willing to invest more effort in finding new solutions. This slows down the development itself and the innovation and the desire and the habit of people to earn their money through their work. On the other hand, there is a large number of entrepreneurs who often do not even try to use certain innovations, or put new ideas because they are obliged to pay interest regardless of the outcome of the same; often the first attempts or years of business can be unprofitable.

Banks in this case are not too eager to finance new projects, for them the only important thing is that loans can be repaid by those who received them. Since they do not care about realized profit they invest only in so-called safe projects. The only thing they care about is that their interest is returned together with borrowed funds. Banks primarily invest in large companies or governmental jobs where their income is guaranteed thus preventing a wider number of users to be financed by banks and thus realize activities that can contribute to economic development.

Financing based on the interest rate automatically increases the cost of financing construction that have increased since the beginning of the same amount of interest. This naturally reduces the number of projects that can be implemented.

Kamatni sistem bogate čini bogatijim, a siromašne siromašnjim. The interest system makes the rich even richer, and the poor even more poor.

Awqaf is the creation of endowments where assets are used for charitable purposes. Historically, Awqaf proved to be a very useful institution in mobilizing assest for the poor and Awqaf-beneficiaries have benefits such as education, health care, access to basic infrastructure and support for entrepreneurial ventures.

#### 5. THE BASIS OF ISLAMIC FINANCE

Prohibition of the riba is the basis of Islamic finance. The aim of the ban on riba is creation of a better society. Islam believes that the interest system is bad and unfair, and that allows the rich to get even richer, and the poor become poorer. Islam, however, does not prohibit the creation of profit and the division since the fundamentals of Islamic finance make partnerships and profit allocation. It is believed that the division of profits brings prosperity for all; one who invests money gets the revenues, but according to the results achieved. He who lends money share the profit with the one who receives investment, depending on the success of the project.

The banking system based on these principles can be strange and odd to those who are accustomed to the conventional banking system based on borrowing money with interest. To better explain this system, it is necessary to make a distinction between the interest that

is achieved by providing loans and interest to be achieved by investing in a certain project. Islamic banking practice this system where profit making is something that should be encouraged. It is believed that it stimulates investment in trade and profit sharing where allowed because it bears the risk of loss and is not able to recover all the money.

Islamic banking is therefore based on various forms of partnerships and other forms of business organizations that have one primary goal and that is the division of profits through joint ventures.

## 6. CONCLUSION

Islamic banking has emerged due to the need of the Muslim population to live according to Sharia law, and as such offers a range of new products accordingly. To respect the rules of Sharia meant the creation of products which are completely different from the products offered by conventional banks and are primarily characterized by interest-free Islamic banking system. The question, however, is the extent to which real interest rates are indeed avoided and whether Islamic banking is truly as human as it at first seems.

The fact is that in Islamic banks there are no fixed interest rates on loans but it is also the fact that banks are making profits in the difference between the price at which you buy products and ceded them to the client, which in practice may even be higher than the interest rates of conventional banks. Banks charge for their services as well as other conventional banks: maintenance of accounts, membership fees for the use of cards, safe deposit boxes, issuing checks, etc. The interest rates for saving deposits are not defined, but a percentage of the share of possible profits realized certainly is. Islamic banks operate primarily on the basis of a contract, particularly in the areas of corporate banking, which is shared profits but also potential losses. The same principle is used when it comes to insurance.

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