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Fatih Varol

Abstract: In this article, my aim is to examine the development of Islamic business (a class of Islamic entrepreneurs and the holding companies based on multi-ownership) and finance (Islamic banking) in Turkey during the 1980s and 1990s. Particularly, I investigate why Islamic business and finance did not emerge until 1980 and what factors played an important role in its emergence in the 1980s. I examine the relationship between the Turkish developmentalism and "state-initiated social engineering" project aimed at modernizing Turkish society through strict secularization policies, to understand why Islamic business and finance did not develop until the 1980s. However, in the 1980s, similar to many countries, Turkey aimed at reducing the role of the state in the national economy through the implementation of neoliberal policies and shifted its political-economy from state-led developmentalism to market-led development. As a result of this transition, Islamic business and finance emerged by taking advantage of the opportunities of financial and political liberalization.

Key Words: Developmentalism, Neoliberalism, State-Initiated Social Engineering, Kemalism, Islamic Entrepreneurs, Islamic Banking

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Introduction

In Turkey, the development of Islamic business and finance (a class of Islamic entrepreneurs, an Islamic banking system and the holding companies based on multiownership) took place in the 1980s. Why did the development of Islamic business and finance arise in the 1980s? In this article, I attempt to understand why Islamic business and finance did not develop until the 1980s and what factors led to the development of Islamic business and finance in the 1980s.

To investigate this question, I examine the relationship between the political-economy of the Turkish state and its impact on the development of Islamic business and finance. I will provide a general historical overview that illustrates

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the influential role of the state, developmentalist policies and the state-initiated social engineering project in Turkish polity. I then examine Turkey's transition to neoliberal policies in the 1980s and its impact on the emergence of Islamic business and finance. Specifically, my question is how neoliberalism paved the way for the development of Islamic business and finance in Turkey. Thus, I use neoliberal policies as a social change paradigm or an analysis method leading to the development of Islamic business and finance in Turkey in the 1980s and 1990s.

Developmentalism and its Relationship with the State-Initiated Social Engineering

"Developmentalism" was the dominant political-economic paradigm in the developing countries from the end of World War I to the last quarter of the twentieth century (McMichael, 1996; Pieterse, 2010). A large array of developing countries in Eastern Europe, East Asia, the Middle East and Latin America shaped their political and economic policies under the impact of the developmentalist paradigm. Therefore, this paradigm is highly significant to understand the political-economic policies of the developing countries, including Turkey, in the 20th century.

Developmentalism emerged in the late industrializing nations as a reaction to the classical liberal economy, which was largely perceived as a tool of western imperialism over the non-western world. In the developmentalist paradigm, the aim was to establish a self-sufficient industrialized national economy. In contrast to classical liberal economy favoring free markets, in the developmentalist paradigm, the state was the major actor in the construction of the national economy, the maximization of national welfare and the industrialization of the country. Under the impact of this paradigm, the developing countries focused on state-led industrialization policies until the late 1970s. The states established a large array of enterprises for the sake of fast industrialization of the national economy. Besides state-led industrialization, the states also established their own national banks to support the national economies and industrialization. In the developmentalist years, the states also protected the national economy from international competition through strict regulations such as fixed exchange rates, limited foreign investment, strict financial restrictions and tariff protections. Therefore, there was limited global intervention in national economies.

In developmentalist countries, major actors in the economy were not free markets and entrepreneurs, but state enterprises and statesmen including politicians and bureaucrats. However, an entrepreneurial class was also created by the state in many developing countries. The entrepreneurs built a close relationship with the state and statesmen to be able to flourish their businesses because of the impact of the state over the national economy. Indeed, they were also integrated into the national economic plans through the cooperation of state planning agencies. The protective tariffs of the developing state allowed state-led business groups to enhance their profit and capital accumulation.

Even if developing countries aimed at protecting their own economies from the west, developmentalism was a politico-economic project aiming to catch up with the life standards of the western world. Therefore, the paradigm of developmentalism was the corollary of the universalization of the western model. That is, developmentalism was to follow a modernization path through a linear and progressive understanding of development. In this paradigm, modernization and westernization were synonymous (Pieterse, 2010, p. 16); thus, for the sake of development, societies needed to follow a modernization project aiming at the westernization of their own societies. The development could not be achieved only through technology, industrialization and science, but it also required from them to follow the west as a role model. As a result of this understanding, even if the meaning of development was mostly understood as an economic growth, it was closely linked to cultural and political development in many parts of the world (Pieterse, 2010: 6). In general, the developmentalist paradigm was closely associated with the nation-building project and was combined with the modernization of other spheres of social life from political sphere to education (Pieterse, 2010, p. 6). As a result of a linear understanding of development, it was necessary to emancipate from the impact of the dogmas of any faith and clerical authority through the development of reason and science (Pieterse, 2010, p. 27). The state in the developing countries generally struggled for the weakening of the impact of religion on society and the promotion of a positive science through mass education. Developmentalist projects thus turned into "state-initiated social engineering" projects in the developing countries.

According to James C. Scott (1998), there are four shared characteristics of state-initiated social engineering projects: (1) "the administrative ordering of nature and society;" (2) A "high-modernist ideology" and its dedication to progress based on a rational design of social order through science and technology; (3) the presence of an authoritarian state that aims to put a "high-modernist ideology" into practice through state power to shape people and society, and (4) the presence of weak or the lack of civil society. Scott suggests that "high-modernist ideology" is different from the practice of scientific knowledge because it is an ideology or a faith in science and technology in an uncritical way. State elites particularly put their project into practice in/after difficult times such as war, revolution, and struggle for national liberation because of emergency situations that allow them to mobilize state power. They can easily denounce the previous regime and promote a new regime or their revolutionary design for society by taking advantage of emergency situations. If there is no strong civil society, state elites can easily materialize their social engineering projects by mobilizing state power without any/strong civil resistance. Difficult conditions such as war, revolution and economic crisis could also lead to the weakening of civil society even if there is a powerful civil society to some degree. In the developing world, "high-modernist" planners had a powerful desire for the improvement of the human conditions as a result of faith in progress and reason, which was a shared characteristic of social engineers throughout the world, in/after difficult times such as times of war, national liberalization and economic troubles. According to Scott, when "high-modernist" planners grab power and wealth, they begin to behave like a god. Scott says: "The progenitors of such plans regarded themselves as far smarter and farseeing than they really were and, at the same time, regarded their subjects as far more stupid and incompetent than they really were" (Scott, 1998, p. 343).

After giving this theoretical background about developmentalism and its link with state-initiated social engineering, we can examine the Turkish developmentalism and "state-initiated social engineering" project to understand why Islamic business and finance did not develop until the 1980s. Here my aim is not to examine the emergence of a high-modernist state in Turkey in detail, but to show the obstructive impact of the Turkish developmentalism and the Kemalist high-modernism on the development of Islamic business and finance.

The Kemalist Development Project and the Absence of Islamic Business and Finance

In the late period of the Ottoman Empire, European companies and non-Muslim groups (e.g. Greeks, Armenians and Jews) of the Empire dominated the Ottoman economy. Although non-Muslim businessmen were Ottoman citizens, they were not loyal to the Ottoman Empire because of their strong sense of nationalism (Ahmed, 1977). They were also closely cooperating with the European capital. Therefore, the Committee of Union and Progress (CUP) tried to eliminate the impact of these groups on the economy of the Ottoman Empire in order to create a national economy based on loyal Turkish businessmen in the late period of the Empire. The CUP encouraged Ottoman bureaucrats and nobles to engage in business activities with the support of the state. Therefore, the CUP was called as "the vanguard of the nascent Turkish bourgeoisie" (Ahmed, 1977).

Although the CUP was not able to materialize its goal because of the collapse of the Ottoman Empire after World War I, the founding fathers of Modern Turkey continued similar policies and implemented nationalist economic policies to weaken the impact of European countries and non-Muslims over the Turkish economy. They aimed to create a homogenous, solidaristic, and self-sufficient national economy (Agartan, 2009, p. 56). Even if there were some liberal tendencies in the early years of the Republic, the idea of economic liberalism was mostly seen as a tool of western imperialism. Therefore, similar to many developing countries, developmentalist policies were the main characteristics of the Turkish economy until the 1980s even if there were some liberal policies in the 1950s. The basic idea was that the backwardness of the country could be eliminated only through statist policies, particularly state-led industrialization. The state was thus involved in almost all kinds of economic activities; it founded new enterprises in many sectors, particularly heavy industrial sectors and established banks to support the national economy.

The Turkish developmentalism was not only a mere economic project, but also part of a bigger project, which was the creation of a new modern nation through the westernization of Turkish society in an authoritarian way (İnsel, 1996, p. 19). Therefore, Turkey's development struggle cannot be understood without taking into account the Kemalist modernization as a social engineering project. The Kemalist elites not only struggled for the industrialization of the country, but also attempted to shape Turkish society in accordance with the Kemalist ideology, which was a high-modernist ideology shaped under the impact of positivist ideas, because of the idea that the reason for the backwardness of the Islamic world, particularly the Ottoman Empire, was the social and cultural structure that was shaped by Islam. They were able to put their modernization project into practice without any serious resistance in the lack of a strong civil society after the independence war of the country. The Kemalist elites were the proponents of a strong state (Heper & Keyman, 1988, p. 260) to increase their capacity to control the economy and to secure the future of the Kemalist social engineering project aiming at the westernization of the country through strict political and cultural secularization. The presence of a strong state did not allow the emergence of a powerful civil society and civil resistance to the Kemalist social engineering project.

The state elites also encouraged loyal people, particularly bureaucrats and politicians, to involve in business activities to manufacture a national bourgeoisie in the early years of Modern Turkey. Therefore, a close relationship with the ruling party (Republican People's Party) was an important way to do business. It was also very difficult to differentiate politicians and high level bureaucrats from businessmen (Keyder, 1987, p. 105). The state (and the state banks) provided the loyal businessmen with cheap credit, tax exemptions, import allocations, state contracts, investment permits (Keyder, 1987, p. 105-106). Thus, the state was the major actor in the manufacturing of the national bourgeoisie in Turkey.

The state-led bourgeoisie integrated into national economic development plans and worked together to shape their policies. While the state was the main actor in the heavy industrial sectors such as steelmaking, mining and chemical industry, the state-led bourgeoisie mostly focused on light industrial products such as household equipment, food and construction. The importation of many goods which were domestically produced was forbidden until the 1980s. An overvalued exchange rate policy also obstructed exportation (Cokgezen, 2000, p. 529; Okyar, 1979, p. 343). Thus, the basic characteristic of this period was the lack of competition. Under the heavy-state protection, the state-led capitalists, who mostly focused on the domestic market, were able to sell their products at high prices in domestic markets (Ergil, 1975, p. 141).

For the Turkish bourgeoisie, it was necessary to have a close and secure relationship with the ruling elites to be successful in the business in presence of the state-centric policies (Buğra, 1994, p. 5). Their success depended on close ties with the state elite. For example, Vehbi Koç and Hacı Ömer Sabancı, the founders of two major conglomerates of Turkey, had close relationships with state elite. In the one-party period of Turkey, Vehbi Koç's close contacts with state elite provided government contracts. Sakıp Sabancı, the son of Hacı Ömer Sabancı, stated that his father had a close relationship with two groups: Bankers and military officers (Buğra, 1994, p. 85). Thus, having a close relationship with state elite was the general characteristic of the Turkish bourgeoisie and played an important role in their growth (Buğra, 1994, p. 78).

As a result of the state protection and support, the state-led capitalists became an important economic actor over time in the Turkish economy. They also established their own business association, "the Turkish Industrialists and Businessmen Association" (TÜSİAD), in 1971. There was a mutual interest between the state elite and the members of TÜSİAD. While the state established a loyal bourgeoisie class as a means of economic development, the state-led bourgeoisie were supporters of the Kemalist modernization project of the new Republic. The bourgeoisie class thus turned into a means for the hegemony of the Kemalist elite and became the civil army of the state (Öncü, 1980, pp. 462-463).

However, those who were not loyal to the ideals of the new Republic were not supported by the state because it was necessary to take the control of the national economy to be able to maintain the Kemalist hegemony (Keyder, 1987, p. 106). Moreover, the state-initiated development projects also aimed at hindering the development of opposed groups, which could be a threat to the Kemalist project. As a result of the huge role of the state in the economy, the state did not permit the emergence of an independent bourgeois class however capital accumulation was out of the control of the state (Erdoğan, 2005, p. 39). As Ayşe Buğra points out, the Kemalist elite were not keen about small size enterprises, shop keepers or *the esnaf* because of their adherence to religious and conservative values (Buğra, 1994, p. 240). They were perceived as a threat to the modernization and secularization of the country. However, the state was in favor of secular and large business groups. The discrimination of the state against the small size enterprises or *the esnaf* shaped the attitude of Islamic entrepreneurs to the Kemalist state and its official ideology (Adas, 2003, p. 39).

As a result of the state-led development under the impact of the developmentalist paradigm and its amalgamation with the Kemalist social engineering project, the development of Islamic business and finance was not possible. For the Kemalist elite, the development of an Islamic economy could be a threat to the modernization and secularization process. Therefore, the founding fathers of Modern Turkey believed that liberal democracy and policies could be a potential source of danger for the state's development strategies and that liberal policies were a mean to weaken Kemalist project. In a liberal atmosphere, Islamic or opposed groups could increase their activities and financial sources within society. However, the state-led development provided the state elite with the control over not only the economy, but also Turkish society.

From Developmentalism to Neoliberalism: The Diminishing Role of the State in the National Economy

There was a shift in development policies all over the world from a "developmentalist paradigm" to a new paradigm, which is called "post-developmentalism," "neoliberalism," or "the globalization project," which emerged in the late 1970s because of the failure of the developmentalist project. While the developmentalist project was constructed in the framework of the nation-state, the post-developmentalist paradigm has been constructed in the context of global markets. Although the defenders of the globalization project argue that neoliberal policies are the inevitable consequence of the globalization process, it is different from the globalization process, which is the increase of the interaction between people, because it is not a new process in the world history. The world has been getting smaller for a long time; therefore, there is not a necessary relationship between the globalization process and the globalization project. However, the globalization process has been turned into a political-economic project promoting the necessity of the restructuring of the states and economies all over the world in accordance with neoliberal economic policies by the global financial elite and international bureaucrats since the late 1970s (McMichael, 1996, p. 27) .

Under the impact of the globalization project or neoliberalism, the meaning of development has been redefined; the World Bank's World Development Report published in 1980 defines development as "participation in the world market" (Hoogvelt, 1985). Under the impact of the global financial institutions, the developing countries began to implement neoliberal policies, which led to the reformulation of the role of the state. Nation-states were no longer aiming to pursue national development projects for their own societies, but they aimed to become part of the global economy. The state, which was the major institution of the developmentalist project, has lost its constructive role in the development and modernization of the countries because of neoliberal policies that pursue the minimization of the state capacities in the regulation of national economic growth (McMichael, 1996, p. 42). A new formulation of the state under the impact of the neoliberal policies led to the decrease of the capacity of the state in shaping the national economies and supporting some privileged groups. The states do not pursue developmentalist policies, but "they position themselves in the global economy" (McMichael, 1996, p. 26). While the nation-states were the main agent of the development project, they limited their roles and turned into the means of the globalization project. They imposed the imperatives of the globalization project on their own populations and began to privatize state enterprises.

As Ong (2006) argues, neoliberalism as a new mode of political optimization reshapes the relationship between the governing and the governed, knowledge and power, and sovereignty and territoriality. Neoliberalism suggests that solutions to social and economic problems are not political, but technical because the aim is to optimize government activities. A mode of "governing through freedom" and limited state for freedom became a dominant discourse all over the world. Neoliberalism as an art of governing observes populations to be free, self-managing, and self-enterprising in every sphere of daily life such as health care, education, bureaucracy, and so on. Thus, individuals are encouraged to be "entrepreneur of himself or herself" (Ong, 2006, p. 14).

Neoliberalism in Turkey and the Development of Islamic Business and Finance

Similar to many developing countries, Turkey begun to implement neoliberal policies in the 1980s under the rule of Turgut Özal, *who was a dedicated* conservative-liberal politician. As a result of neoliberal policies, the Turkish economy experienced a major shift from protectionism to a free market economy in line with the desire of neoliberal globalization. The aim of the state was no longer to protect the Turkish economy from foreigners, but to open the national market to international competition and the privatization of the state enterprises. Neoliberal policies also led to the growth of an export-oriented economy; therefore, Turkey experienced an export boom because of its integration into the globalized world.

On the other hand, there was also a strong resistance to the implementation of neoliberal policies. The Kemalist elite resisted the minimization of the role of the state for the continuity of the Kemalist project. The state-led businessmen represented by TÜSİAD, also did not support the liberalization of the Turkish economy (Agartan, 2009, p. 118). For them, it was difficult to adapt their economic activities to an export-oriented free market economy (Agartan, 2009, p. 119); therefore, they struggled for the continuation of the state protection against foreign investments. However, Özal's policies represented a turning point in the state's policies and led to the shift from a statist mentality to a neoliberal mentality in Turkey. In a liberal state, as Ong (2006) points out, people do not expect the state to find a solution for their economic problems; but, they need to adapt to liberal policies to survive in a free market economy. Thus, one of the most important consequences of the neoliberalization of the Turkish economy was the decline of the protective role of the state in the development polices for the country.

The Emergence of an Islamic Entrepreneurial Class

The state under the rule of Turgut Özal urged an entrepreneurial spirit and encouraged citizens to involve in entrepreneurial activities not only in Turkey, but also all over the world. The state also began to grant tax exemptions for exportations to encourage businessmen. The birthplace of the new entrepreneurial spirit and a new wave of exportation were conservative Anatolian cities such as Kayseri, Konya, and Gaziantep. These cities experienced enormous economic growth and turned into trade and industrial centers in the 1980s. Conservative entrepreneurs began to turn their small-size family enterprises into large conglomerates as a result of their export-oriented businesses in order to become global players in manufacturing and trading. Hence, traditional shop keepers or *the esnaf* could be regarded as the origin of newly-emerged conservative entrepreneurs, they were different from *the esnaf* in terms of their business activities and ambitions. In contrast to the traditional businessmen who possessed a small shop or workshop, newly-emerged conservative entrepreneurs had an ambition to enhance their businesses through risk taking and entrepreneurial spirit, and were able to fulfill the requirements of competitive global markets such as institutionalization, rational calculation and openness to innovativeness.

Conservative entrepreneurs established their own business association, "the Association of Independent Industrialists and Businessmen" (MÜSİAD) in the year 1990. MÜSİAD has played a very active role in organizing conservative businessmen and its influence has gradually increased in the Turkish economy. A large number of the members of MÜSİAD are the owners of small and medium size companies which were established after 1980 (Atasoy, 2008; Buğra, 1998) some of which grew into large holding companies over time. These companies work in almost all economic sectors; but, the largest sectors are textile and construction. These companies are generally export oriented; thus, they have benefited from neoliberal capitalism and increased their wealth in the globalized world because of their export-oriented business. The members of MÜSİAD have a lot of partners throughout the World. Therefore, MÜSİAD has branches in many countries including Germany, Netherlands, England, Austria, Belarus, Denmark, France, Romania, Belgium, South Africa, Australia, the United States, China, Pakistan, Malaysia, Indonesia, Singapore, Egypt, Sudan, Jordan, Saudi Arabia, Iran, Bangladesh, Nigeria, and Bosnia. MÜSİAD provides numerous services and opportunities to its members to expand their benefits in the global markets. For example, it organizes business trips to many countries; publishes brochures and journals which evaluate general economic conditions and informs its members of new opportunities. Thus, MÜSİAD is not only a representative of Islamic entrepreneurs, but also an important agent which plays an important role in the integration of conservative entrepreneurs into the competitive global markets and world economy by decreasing the information cost.

Table 1
Dates of incorporation of MÜSİAD and TÜSİAD companies

	MÜSİAD		TÜSİAD	
Years	Number of Companies	%	Number of Companies	%
Before 1950	28	1,6	15	5,0
1950-1959	42	2,4	32	10,6
1960-1969	85	4,8	56	18,6
1970-1979	283	16,1	107	35,5
1980-1989	739	42,1	85	28,2
After 1990	579	33,0	6	2,0
Total	1756	100,0	301	100,0

Source: MÜSİAD Catalogue of 1995 (in Buğra, 1998, p. 525); TÜSİAD Catalogue of 1991 (in Cokgezen, 2000, p. 531).

MÜSİAD is generally considered as an alternative to the secular businessman association (TÜSİAD) (Atasoy, 2008; Buğra, 1998; Keyman & Koyuncu, 2005). These two business associations represent the hegemonic struggles between the Kemalist elite and the Islamic elite in terms of economic models and their relationship with the state (Buğra, 1998, p. 522). While TÜSİAD is a secular association which had a close relationship with the state elite, the members of MÜSİAD had weak ties with the state elite until 2000s. As Table 1 shows, 71% of TÜSİAD members were established before the 1980s whereas 75% of MÜSİAD members emerged after 1980. This table also shows that there were some conservative businessmen and business groups which emerged before the 1980s. However, neoliberal times of the 1980s were the breakpoint in the development of conservative businessmen as an effective and powerful class in the defense and representation of Islamic ethics and values in the Turkish economy. In terms of geographical distribution, as Table 2 shows, while 88% of TÜSİAD companies were located in three biggest cities (i.e., Istanbul, Ankara, and İzmir), particularly in Istanbul (68% TÜSİAD members) (Cokgezen, 2000: 531), MÜSİAD companies dispersed throughout Anatolian cities. Even if Istanbul had the highest number of MÜSİAD companies, there were a remarkable number of MÜSİAD companies located in Anatolian cities (72% of MÜSİAD members), particularly in the conservative cities of Anatolia such as Konya, Kayseri, Bursa, Denizli, and Gaziantep. The statistical data (Table 1 and Table 2) helps us draw the conclusion that a large number of Islamic businesses emerged in the 1980s and 1990s in the conservative cities of Anatolia. While the developmentalist paradigm and its articulation with the Kemalist social engineering project hindered the development of a class of Islamic businessmen until the 1980s in Turkey, the shift from state-led developmentalism to market-led development allowed the emergence and development of Islamic entrepreneurs as one of the major actors in the Turkish economy.

Table 2
Geographical Distribution of MÜSİAD and TÜSİAD Member Companies

	MÜSİAD		TÜSİAD	
Cities	Number of Companies	%	Number of Companies	%
Ankara	175	10,2	24	5,1
Bursa	99	5,8	5	1,1
Denizli	75	4,4	0	0
Gaziantep	61	3,6	0	0
İstanbul	488	28,4	323	68,3
İzmir	114	6,6	61	12,9
Kayseri	112	6,5	0	0
Kocaeli	89	5,2	4	0,8
Konya	153	8,9	17	3,6
Other Cities	351	20,4	39	8,2
Total	1717	100	473	100

Source: MÜSİAD Catalogue of 1995 (in Buğra, 1998, p. 530); TÜSİAD Catalogue of 1989 (in Buğra, 1998, p. 527).

The Emergence of Islamic Banks

Another important development in the neoliberal times of 1980s was the emergence of an Islamic banking system in the 1980s. Although the Islamic banking system emerged in the 1960s and institutionalized in the 1970s in the Islamic world, particularly in the Gulf countries, it appeared in Turkey in the mid-1980s. In the 1980s, Turgut Özal aimed to ease the flow of the Gulf capital into the Turkish economy during the neoliberal times. As a result of Özal's endeavors, the financial groups of the Gulf countries began to invest in the Islamic banking system in Turkey. In 1985, two Islamic banks, Al-Baraka Finance and Faisal Finance, were established in Turkey with help of the Saudi capital. Then, the Kuwait Finance House established an interest-free bank (the Kuveyt-Turk Finance) in 1989. Turkish business groups also began to establish their own Islamic banks in the 1990s. In the recent years, state-owned banks (e.i., Ziraat Bank and Vakıf Bank) also began establishing their own Islamic banks (Ziraat Katılım Bankası and Vakıf Katılım Bankası). In today's Turkey, there are five Islamic banks: Kuwait-Turk, Al-Baraka Finans, Türkiye Finans, Ziraat Katılım, and Vakıf Katılım.

The major aim of an Islamic banking system is to provide Muslims with financial services in accordance with Islamic norms and Qur'anic principles. Before the emergence of Islamic banks, religious people did not invest their savings in conventional banks because of the prohibition of interest in Islam and kept their wealth away from capital flow (Atasoy, 2003-2004). However, after the establishment of the Islamic banks, many practicing Muslims have deposited their money in the interest-free Islamic banks. Thus, conservative entrepreneurs who are involved in business activities are able to utilize the Islamic capital. The growth of Islamic entrepreneurs has paralleled the growth of the Islamic banks in Turkey. In this way, the wealth of practicing Muslims has begun to flow to Islamic entrepreneurs. Therefore, these banks have an important role in the accumulation of capital for Islamic entrepreneurs (Atasoy, 2008) and have led Islamic companies to flourish in the Turkish and global economy. The share of Islamic banking in the financial sector was 0.8% in 1986, 3.7% in 1999, and 5.2 % in 2015 in terms of funding.

On the other hand, even if conservative entrepreneurs wished to utilize a business loan from conventional banks, it was difficult to obtain enough funding for many of them until recent times because conventional banks generally belonged to the state or the state-led business groups. The state banks were under the control of political authorities who had close ties with the state-led bourgeoisie. For example, small firms utilized only 2.7 % of bank credits, including state banks, in 1974 because banks mostly supported the large business groups (Atasoy, 2005, p.117). Therefore, conservative entrepreneurs who could not take a business loan from a commercial bank and those who did not want to involve in any business activities that included interest did business with the Islamic banks.

Islamic Holding Companies

The Islamic banks were not able meet the needs of conservative businessmen in terms of funding. Therefore, conservative entrepreneurs those who were not able to utilize business loans focused on alternative ways of finding secure capital for their investments and began to utilize the savings of Turkish migrant workers in Europe in the 1980s and 1990s. They collected millions of dollars from Turkish overseas workers and invested the capital all over the world, particularly in Turkey. Thus, conservative and religious Turkish workers in Europe were also an important factor in the growth of Islamic entrepreneurs (Ozcan & Cokgezen, 2003).

Turkish workers began to migrate to European countries, particularly Germany, in the early 1960s. The number of migrants kept increasing until 1970s. While the number of Turkish workers was 13,000 in 1962, it became 800,000 in 1974 (Keyder, 1987). Today, there are approximately 5 million Turkish workers in Europe. Their impact on the Turkish economy has been highly considerable since the 1960s because of the flow of the savings of overseas workers into the Turkish economy. In the 1960s and 1970s, state-centric projects were put into practice to utilize the savings of the migrants. In the 1970s, the state utilized their savings to facilitate the national economic growth. Hence, "Anatolian holding companies" were established by the State Planning Organization (Ozcan & Cokgezen, 2003). Thousands of migrants invested their savings in these holdings to gain good returns. In the mid-1970s, there were 322 workers' companies based on multiownership in Turkey (Ozcan & Cokgezen, 2003: 2068). A large number of them had more than 100 shareholders (Ozcan & Cokgezen, 2003: 2068). They worked in collaboration with the state and state banks. The choice of investment and its place were directed by the Turkish government via the State Planning Organization. The companies and factories were mostly located in the hometowns of the migrants for the sake of local development. Their places were mostly far away from industrial and commercial centers. Therefore, investment decisions were not made through rational choices and calculations. Also, the capabilities of the investors were not enough to manage a company. As a result, these companies went bankrupt; and the state had to purchase these companies (Ozcan & Cokgezen, 2003). As one can notice, the state was very active in the administration of the national economy and of the savings of the migrant workers. The state also aimed at manufacturing an entrepreneurial class from workers in the 1970s.

In the 1980s and 1990s, conservative entrepreneurs began to mobilize the savings of the Turkish migrant workers in Europe by establishing holding companies based on multiownership. They sold the shares of their holding companies for the accumulation of capital. They therefore developed close ties with conservative Turkish migrant workers and utilized Islamic discourse to sell their holding shares. They were mostly established in the conservative towns of Anatolia such as Konya, Yozgat and Kayseri. Some of these holdings such as Kombassan and Yimpaş turned into large conglomerates doing business in many countries. For example, the Kombassan Holding invested in many sectors such as construction, textiles, energy, food, etc. The founder of Kombassan, Haşim Bayram, was a chemistry teacher in a high school in Konya. He had some projects, but could not find any financial resources in the 1980s. One of his student's fathers helped him establish the Kombassan Holding in 1989. Then, Haşim Bayram developed close ties with migrant workers and collected their savings to enhance his business. Thus, Kombassan became a giant conglomerate in a short time. There was no reliable data on the number of shareholders, but it was about 30 thousand in the mid-90s and employed about 8 thousand people (Ozcan & Cokgezen, 2003, p. 2072). Many people believed that the Kombassan was an economic miracle, and therefore invested their savings into the Kombassan. Another well-known example was the Yimpaş Holding founded by Dursun Uyar in 1982 in the city of Yozgat. He was also a high school teacher in Yozgat. Yimpaş also mobilized the savings of conservative people in Turkey and Europe and became a large conglomerate by using them. Yimpaş had also about 10 thousand employees and 30 thousand shareholders in 1997 (Ozcan & Cokgezen, 2003, p. 2072).

According to the owners of the holding companies, those who invest their money into these companies not only made investment, but also helped the Islamization of Turkish society. Thus, thousands of workers in Europe invested their savings in these companies such as Kombassan and Yimpaş. The holding companies collected large investment funds from conservative workers in Europe until the February 28 coup of 1997, which was a soft military coup against Islamic movements, and the financial crisis of 2001. The collected amount reached billions of DM in the 1990s. For example, in 1990, Turkish overseas workers in Germany invested 2 billion DM into the Kombassan Holding (Adas, 2003, p. 84).

In this system, those who invest their savings into these holdings got shares of these holding companies and were considered one of the owners of the holding company. These companies also had annual meetings in order to inform their shareholders. The founders of the holding companies were generally elected to the administration of the company by shareholders in the annual meetings. There were thousands of depositors; and the profit was shared among shareholders in accordance with the percentage of their shares. It was also possible to lose savings, but depositors began to take good returns in a short time because the annual profit of these holdings generally was very high (Ozcan & Cokgezen, 2003, p. 2071).

In the 1980s and early 1990s, there was no a major problem between depositors and the holding companies (Ozcan & Cokgezen, 2003) because of a trustworthy relationship between depositors and the holdings. However, there was also no a legal framework that regulated these holdings. These holdings were based on trust between depositors and the administration of the holdings; the source of the trust was Islamic morality. The number of these holdings mushroomed in a short time and reached approximately 200 holding companies; and some of them began to abuse the system. They collected the savings of people, but did not make any investment. Some of them got involved in irrational investments to grow their businesses quickly. Therefore, many of them collapsed in the late 1990s and a large number of depositors lost their savings.

Besides the internal complications and problems of the system, during the February 28 process, the holdings experienced serious difficulties in their business. The Kemalist state elite put pressure on people to not do business with Islamic companies and to not purchase any of their products. The Turkish media, secular business groups, and trade unions also supported the February 28 coup. Newspapers published the list of Islamic companies. The state also began to investigate these companies in order to pressurize them. Thus, people alienated from these companies after the February 28 takeover. They could not overcome their financial difficulties and many holdings went bankrupt. Some of these companies are still active in the Turkish economy, but not popular because people do not trust them. Nevertheless, the importance of these holdings for the concern of this article is that these holdings played an important role in the emergence of Islamic business in the 1980s and 1990s by using the opportunities of neoliberalization of Turkey.

Conclusion

Although there were different policies, the developmentalist paradigm, which encouraged the state to be the fundamental driving force of economic development, was the basic characteristic of the politico-economic policies of the developing countries including Turkey in the 20th century. After the foundation of Modern Turkey, the state elite also carried out a "state-initiated social engineering" project aiming at the modernization of the country through strict secularization policies.

Developmentalist policies and its articulation with the Kemalist social engineering project provided the Turkish state and political authorities with enormous opportunities of designing Turkish society in accordance with their own social engineering projects until the 1980s. Thus, state-led development, state favoritism toward secular business groups, and the Kemalist repression toward Islamic groups and movements did not allow the development of Islamic business and finance in Turkey. However, in the 1980s, there was a shift in the political-economy of Turkey from developmentalism to neoliberalism. This can also be identified as a shift from state-led development to market led-development. It led to the demise of the strong state and the developmentalist projects. As a result of the diminishing role of the state, Islamic business and finance emerged in the free atmosphere of neoliberal policies.

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The Effect of Retail Loans on Bank Profitability

A Comparative Empirical Analysis

Yusuf Dinc

Abstract: Retail loans became an important instrument of banking during 1960s. The effect of retail loans, in which mortgage and consumer loans have a great share, in the profitability of banks has not been analyzed in detail so far. The main items of retail loans, like mortgage and consumer loans, contribute greatly to the risk management of banks with their characteristics like having regular cash flow in banks. Due to the structure of the guarantee and mortgage loans, which provides low risk weight, it is important to determine the capital needs of banks. However, due to relatively long maturity structure, mortgage loans also feed the maturity mismatch risk, which is the basic problem of banking system. Such loans, with which low costs are provided in favor of the clients, play a considerable role in the profitability of banks. Consumer loans, on the other hand, are provided to the clients in shorter maturity periods and with costs that are more in favor of banks. In the scope of this study, the effects of retail loans on conventional banks and participation banks, which are active in Turkey, have been investigated for mortgage and consumer loans. The findings of the study show that retail loan types have strong negative effects on Net Interest Margin (NIM), which has been selected as the profitability indicator for conventional banks in the scope of the study. For Participation Banks, on the other hand, unlike conventional banks, retail loan types have stronger and more positive influences on Net Profit Share Margin (NPSM). The findings of the present study are important for further studies that will be conducted on retail banking and for comparative studies on performance assessment.
Key Words: Retail Loans, Profitability, Islamic Banking, Comparison, Participation Banking
JEL Codes: G21, G29

Introduction

The present economic model has acquired an important success with its direction towards supply. Today, any production activity may be performed at any place all over the world. The success of banking in the transfer of resources has been influential in the success that has been realized on the supply side. Basically, banking is the financial and intermediary activity for the purpose of financing investments. The success of the present economic system on the supply side has given birth

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to many prospective solutions for the problems of demand side. For this reason, banking system has evolved towards financing the consumption from financing the investment, which is its basic function in reality (Dinc, 2017, p. 4).

The increase in consumption of goods being produced is basically possible with the increase in the income. Alternatively, the opportunity of going into debt is used. Although liberal policies do not provide adequate solutions in improving income levels, they have succeeded in improving the functions of banking system that works on the demand side together with technology. Calder analyzed this transformation in the context of a consumption based society, and considered the demand side as the cause of evolution of the loan concept (2009, p. 24).

Today, 20% of the total loans of the banking system in Turkey consist of retail loans. In addition to this, 54 million credit cards were added to the economy. With the influence of technological developments, the distribution channels of the banking system were diversified, and more people could be reached. Mortgage and consumer loans have an important share in retail loans. These loans have direct effects on the profitability of the banking sector, as well as affect prices and commissions because of being suitable for cross sales.

The loan portfolios of conventional banking and participation banking differ in Turkey. Participation banking shows a portfolio structure in which retail loans have relatively lower shares. On the other hand, the mortgage loans of participation banks have 90% share in retail loans. Although conventional banks have a stronger share in retail loans, the share of the mortgage loans is around 46% in their portfolios. While the consumer loans of participation banks have a limited share in total retail loans, the share of consumer loans in conventional banking is around 50% as seen from Banking Regulation and Supervision Agency (BRSA) data set. It is possible to consider that using the consumer loans for the aims, which are out of the scope of its real nature, is influential in the share of these loans being greater in conventional banking because such loans are paid in cash. Consumer loans are used actively in the requirements of finance to purchase houses and vehicles.

In this study, the effect of mortgage and consumer loans on the profitability of conventional banks, which were active in Turkey between January 2005 and February 2017, was investigated in a comparative manner. The findings are presented with interpretations in the present study in which the linear regression model has been used. This study is important in that it explains the differentiation of participation banks from conventional banks for the first time from the retail loans perspective. In addition, it shows the separation between different dynamics of participation banks and conventional banks. It is important for further academic studies because it shows the trends in this field. The findings are also important for the professionals in banking sector.

Retail Loans

Retail banking practices, which are known as individual banking or consumer loans, emerged at a global scale in the year 1960 (Tschoegl, 1987, p. 67). However, Cardel analyzed the topic in his work by focusing on the United States of America (USA), and revealed that retail banking activities had started around the year 1920 (2009, p. 16). Economic problems stemming from inadequate demand were influential in the emergence of retail loans. The inability of modern economic model to produce solutions for wealth distribution overshadowed the success of capitalism on the supply side. The level which was achieved by capitalist model on the supply side accelerated the decrease in the efficiency of money and capital markets that provided idle resources. The money and capital markets, which had problems in terms of supply-demand function, started to seek alternatives, which is closely related with the development of individual banking. Meanwhile, technological developments also made it possible for banks to establish a healthy-working structure in this field. While the development of alternative distribution channels made it possible to reach more individuals, the increasing consumption demand ensured that individual banking was accepted by societies more and more over time. These developments were diversified in the direction of providing the finance for consumption and payment systems instead of financing investments, which is the basic function of banks.

The development of banks in retail banking field diversifies the structure of the active balance sheets of banks. Meanwhile, individual banking activities in which cash flow was more visible brought with them the developments in the field of securitization. In this way, it was ensured that specialties were developed in the field of risk management, and the risk was diffused to the base. The field of retail banking, which brought a better risk management, became influential in the empowering of the resources and profitability (Bluhm et al., 2016, p. 57). Meanwhile, the obstruction in demands side stemming from problems in wealth distribution, was overcome in a temporary manner by developing certain '*debt channels*'. In this way, a structure was established in which the *demand* that was fed would feed the *demand* again after creating new employees with the need for investment, and then the employment for the investments. It is possible to consider that retail banking has positive effects on growth with such properties. Especially in developing economies, it is observed that this effect occurs more easily.

Development of Retail Loan Types in Turkey

The most important financing types in individual loans are the consumer, mortgage and vehicle financing. Specifically, in Turkey, individual banking is developing over the consumer and mortgage financing. 46% of the individual banking, which has 20% share in total banking sector, comes from mortgage financing. The remaining substantial part consists of consumer financing. In this context, individual banking is a side of the crowding out effect. 20% of the usable funds are transferred to consumption instead of investments. For this reason, the amount of the resources that are the basis of investments decreases; and what is more, the cost also increases.

For this reason, the literature on the *crowding out effect* must be developed since the retail loans crowd out corporate financing. The numbers in the given figures below help illustrate this effect. The 2016 year-end total loans of Turkish banking system reached 1.734 billion TRL which included 337 billion TRL retail loans.

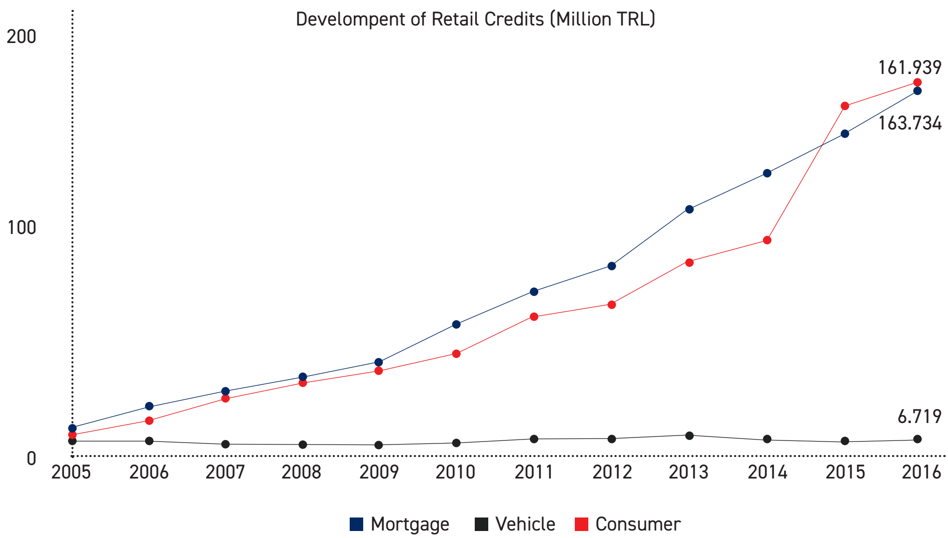

Figure 1: Development of Retail Loans in Turkish Banking System

Source: BRSA (Banking Regulation and Supervision Agency) Dataset

It can be seen in Figure 1 that the basic retail loan types of Turkish banking system are mortgage and consumer loans. It is possible to consider that a certain part of consumer loans is used in vehicle financing due to their open form in a market where vehicle loans have a limited share. In this context, consumer loans may also be used beyond their basic purposes and function.

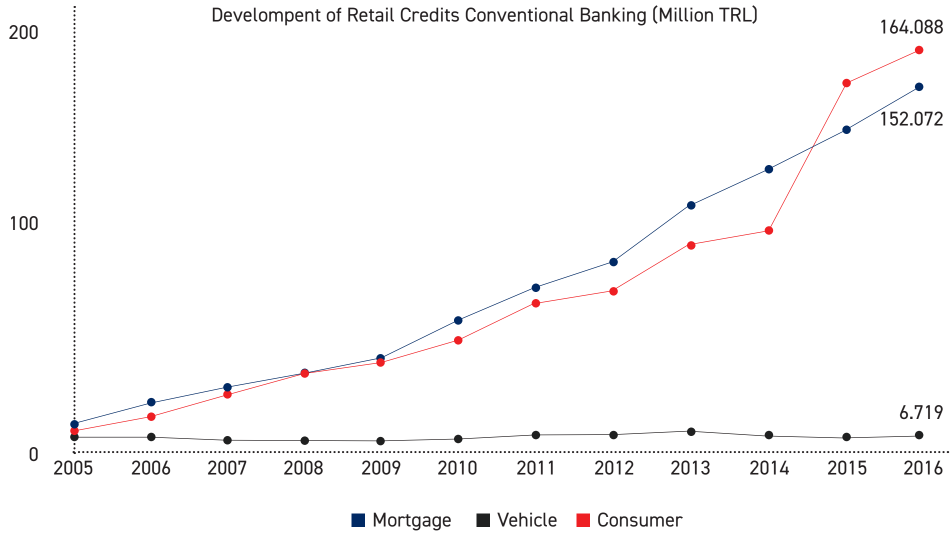

Figure 2: Development of Retail Loans in Conventional Banking

Source: BRSA (Banking Regulation and Supervision Agency) Dataset

Since conventional banks are the basic "*engines*" of Turkish banking system, they provide values that are parallel to this sector. In Figure 2, the development of the retail loans of conventional banks is shown. The loan concept of conventional banking in Turkish banking system is uncertain since it uses the consumer loans for purposes outside the scope of their basic functions. Since the interest-based system provides retail loans in cash in consumer loans, and since there are no limitations for the use of such loans, consumer loans may be used for purposes that are out of their basic scope (Dinc, 2017, p. 65).

In participation banking, since loans are not provided in cash form, it is the basic requirement to provide information and document the use of financing. For this reason, participation banks, which have limited share in consumer loans market, are strong within their own portfolios with mortgage and vehicle financing.

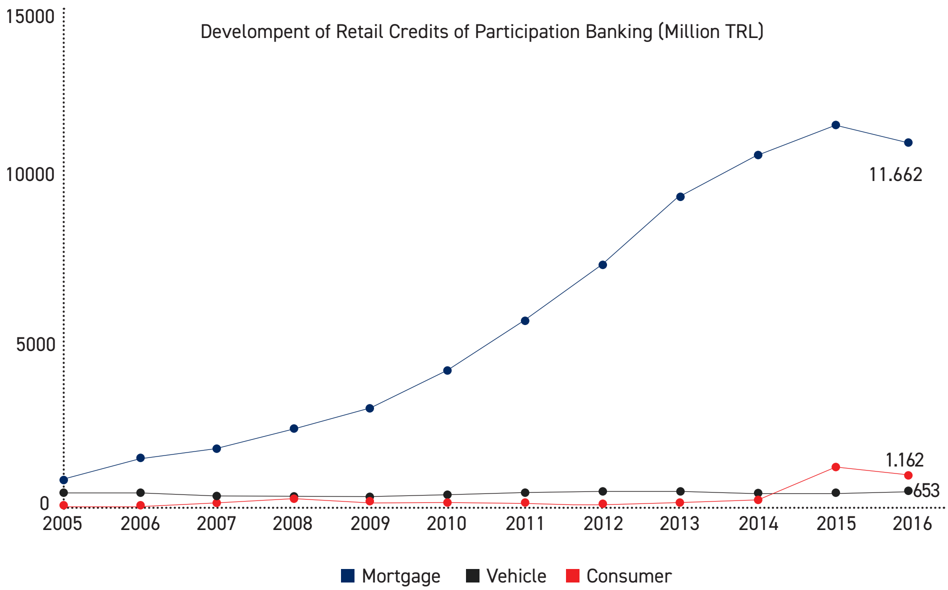

Figure 3: Development of Retail Loans in Participation Banks

Source: BRSA (Banking Regulation and Supervision Agency) Dataset

As it is seen in Figure 3, vehicle loans in participation banking had been surpassing the consumer loans along the 2005-2014 period. In the last period, it can be observed that consumer loans were stronger. However, it can also be seen that mortgage financing, which is more suitable for the functioning of participation banks, constituted the major part of the retail loan portfolio of participation banks.

Comparative Analysis of Retail Loan Performance

Retail loans have become the active power of the product development side of banking. Menor and Roth conducted an empirical study on retail loans and determined that the effect of developing new products was clear for this loan type (2008, p. 280). Cohen and Mazzeo (2007) conducted another study and determined that product development provided additional profitability.

On the other hand, it is also seen that retail loans are handled as the intermediaries of risk management through regular cash flow. Allen et al. (2004) conducted another empirical study to determine the risk weight and capital adequacy for the retail loans. Hirtle et al. (2005) conducted a study in the USA for 1997-2004 period, and investigated the effects of retail loans on performance. In this respect, Hirtle et al. used regression analyses and included some variables like loan-to-asset ratio, deposit-to-asset ratio, and capital ratio. Among the findings of the study, they mentioned that retail loans contribute to the profitability at a low rate, however, they have an important contribution in terms of stability.

Hasan et al. (2012) investigated the effects of retail products on banks performances, and examined the economies of 27 European countries. The regression method was used in the study for 2000-2007 period. Among the variables of the study, there were the loans, deposits and equity values. It was shown in the findings of this study that the contribution of retail loans to the performance stemmed from '*fees*'.

Comparative studies on retail banking are limited in the literature. However, there are several studies dealing with the performance of participation banks and conventional banks in a comparative manner. In such studies, it is observed that linear regression method has been widely used. Ibrahim (2015) conducted a comparative study for the United Arab Emirates for 2002-2006 period, and showed that Shariah compliant banks produced better performance in terms of liquidity, profitability and capital structure. Loans, capital assets and similar variables were used in this study. Youssef and Samir (2015) conducted an empirical study for Egypt and used the linear regression method. The loan-loss reserves, capital assets and the scale were taken as the variables in the study. Among the findings, there is one claiming that there were no differences between the two banking groups in performance. Mollah et al. (2016) conducted an empirical study for 2005-2013 years for 14 countries. The regression analysis was used in this study as well, and it was shown that Islamic banks were highly capitalized.

Method

The effects of retail banking on the profitability of Turkish banking system have been analyzed in a comparative manner. The data of conventional and participation banks for January 2005 - December 2015 period has been used, and the dataset were received from BRSA. The findings of the investigations in which linear regression method was used have been shared and interpreted in the study.

The basic equation of the econometric model used in the study is as follows;

$$NIM_t = \alpha + \beta_1 TCTA_t + \beta_2 NPL_t + \beta_3 CoR_t + \beta_4 TDTA + \beta_5 EQTA + \beta_6 COTC + \beta_7 MOTC + \sigma NIM_{(t-1)} + \mu_t$$

The model was run in a dynamic manner to avoid autocorrelation problem. NIM (NPSM) was taken as the dependent variable. The regression results were reported for the NIM (NPSM) dependent variable and the relation between other variables was reported as well. In the model; α represents the model constant, β represents the vector of the coefficients, σ represents the coefficient of the Dynamic Variable, and μ represents the error vector. The variables and the explanations are given in Table 1.

In the context of this study, monthly data of the conventional and participation banks that are active in Turkey between 2005 January - 2015 December were obtained from BRSA database, and were modelled with linear regression method. A total of 131 observations were reached. Both group data were taken as consolidated data. The bank-based data being not received on monthly basis was among the limitations of the study.

Table 1
The Variables used in the Model

Rank	Ratio	Type	Source	Formula
1	(NIM (NPSM	Performance	Financial Reports	Interest Income – Interest Expense/ Total Assets
2	TCTA	Risk	Balance Sheet	Total Loans/Total Assets
3	NPL	Risk	Balance Sheet	Non-performing Loans/ Total Loans
4	Cost of Risk (Cor)	Risk	Balance Sheet	Non-performing Loans Equivalent/Loans
5	TDTA	Liquidity	Balance Sheet	Participation Funds (General Deposit)/Total Liabilities
6	EQTA	Liquidity	Balance Sheet	Shareholder Equity/ -Total Assets
7	COTC	Risk	Balance Sheet	Consumer Loans/Total Loans
8	MOTC	Risk	Balance Sheet	Mortgage/Total Loans
9	1-NIM t			Dynamic Variable

The control variables are common in the literature moreover COTC and MOTC ratios are unique for this research.

Findings

The model was run for the participation banks and conventional banks. A two-stage process was followed in the estimation of the multi-variate regression models. Firstly, the reference model, which included all the variables, was estimated, and then the models that gave the most meaningful coefficient values were reached by eliminating the variables that produced the meaningless coefficient estimations one-by-one.

Since nearly all of the models that were estimated gave extremely high R-square values, it is observed that their explanation powers are high. The “F” values that are high and have a value at 1% level indicates to high-level general meaningfulness of the models. The model was run in a static manner and the issue of whether there was an auto-correlation problem was tested with Durbin-Watson test and Durbin-h test. In order to prevent the auto-correlation problem, the model was run in a static way. The results of these tests show that there were no such problems in the model. In the context of these determinations, an auto-correlation result emerges for conventional banks. The conventional banks group did not stay within the acceptable limits for both tests. No drawbacks were considered in interpreting the coefficients of the meaningful models for participation banks. The regression results calculated for NIM (NPSM) are as follows.

The findings were obtained by modelling the data for participation banks and conventional banks. For both bank groups, the model was run separately for NIM and NPSM dependent variables. The findings were reported and the results were interpreted.

Participation Banks

The data for the conventional banks between January 2005 and December 2015 were used; and the descriptive statistics and correlation matrices are given. Table 2 shows descriptive statistics for selected variables of participation banks.

Table 2

Descriptive Statistics of Participation Banks

	NPSM	TCTA	NPL	CoR	TDTA	EQTA	COTC	MOTC	CAR	NPSM t-1
N of cases	131	131	131	131	131	131	131	131	131	132
Minimum	0.030	0.573	0.031	0.021	0.606	0.085	0.000	0.047	0.107	0.030
Maximum	0.068	0.782	0.077	0.059	0.848	0.145	0.010	0.178	0.169	0.068
Mean	0.044	0.681	0.045	0.030	0.731	0.111	0.002	0.114	0.142	0.044
Standard Dev	0.010	0.047	0.011	0.009	0.071	0.017	0.002	0.033	0.013	0.010
Skewness(G1)	0.146	-0.168	0.805	1.619	-0.329	0.243	2.707	0.191	-0.817	0.146
SE Skewness	0.212	0.212	0.212	0.212	0.212	0.212	0.212	0.212	0.212	0.212
Kurtosis(G2)	-1.381	-0.378	-0.151	2.329	-1.102	-1.141	5.989	-0.837	0.655	-1.381
SE Kurtosis	0.420	0.420	0.420	0.420	0.420	0.420	0.420	0.420	0.420	0.420

When the correlation matrix in Table 3 is analyzed it can be seen that many variables have strong effects on the NPSM variable of participation banks. The negative relation between the growing value of TCTA ratio with NPSM ratio is due to the strong relation between TCTA ratio and NPL ratio. Meanwhile, it is also possible to consider that the capital requirement of loans has a negative effect on performance indicator. On the other hand, the relation between COTC, MOTC, which are individual loan types, and the dependent variable may be explained with the low capital requirement of mortgage loans and with the relation between these loan types and NPL.

Table 3
Pearson Correlation Matrix of Participation Banks

	NPSM	TCTA	NPL	CoR	TDTA	EQTA	COTC	MOTC	CAR	NPSM t-1
NPSM	1.000									
TCTA	-0.319	1.000								
NPL	-0.384	-0.548	1.000							
CoR	-0.376	-0.491	0.902	1.000						
TDTA	-0.895	0.463	0.252	0.355	1.000					
EQTA	-0.321	0.688	-0.201	-0.334	0.379	1.000				
COTC	0.454	-0.657	0.329	0.236	-0.598	-0.489	1.000			
MOTC	0.799	-0.510	-0.292	-0.341	-0.891	-0.477	0.662	1.000		
CAR	0.140	0.136	-0.297	-0.469	-0.274	0.439	0.063	0.333	1.000	
NPSM t-1	0.965	-0.325	-0.365	-0.354	-0.886	-0.322	0.459	0.800	0.165	1.000

Another important finding shows that the TDTA ratio has a strong negative effect on NPSM due to its strong effect on profit share expenses. When the model findings are analyzed it is seen that the majority of the variables are at an acceptable level in terms of significance. However, it is also clear that total loans are not included in the most significant model. The findings of regression are given in Table 4.

Table 4
Regression Findings

	NPSM			Most significant model		
Independent Variables	Coefficient	t Test		Coefficient	t Test	
Constant	0.067	4.726	***	0.061	6.544	***
TCTA	-0.013	-1.082				
NPL	-0.206	-2.934	**	-0.168	-3.050	***
CoR	0.177	2.163	***	0.172	2.119	**
TDTA	-0.048	-4.803	***	-0.052	-5.711	***
EQTA	0.073	2.768	***	0.051	2.577	**
COTC	0.050	0.256				
MOTC	0.003	0.137				
CAR	-0.087	-3.290	***	-0.075	-3.524	***
NPSM t-1	0.632	11.432	***	0.641	11.816	***
R Square	0.950			0.949		
Flat R Square	0.946			0.946		
F Test	252.784			382.166		
	[0.000]			[0.000]		
Durbin Watson Test	2.270			2.274		
Std. Error (1)	0.002			0.002		
Observation Number	131			131		

(1) Standard error of the delayed variable.
Meaningful t tests at (***) %1, (**) %5, (*) %10 levels.

In addition, individual loan types are not included in the most significant model. Right at this point, it is understood that strategies are developed over the aggregate loan portfolio. In this respect, participation banks are inclined to create an average profitability and capital requirement over different loan types. This situation might pose advantages as well as several disadvantages. This may provide an advantage in terms of the holistic management concept, but it will also cause the imbalance when the loans in the portfolio are removed with some activities like securization. In this context, the securitization activity of participation banks for individual loans is not suitable because it will change the profitability and risk structure of the total portfolio.

Conventional Banks

The data for the conventional banks between January 2005 and December 2015 were used; and the definitive statistics and correlation matrices given in Table 5 show descriptive statistics for selected variables of conventional banks.

Table 5

Descriptive Statistics for Conventional Banks

	NIM	TCTA	NPL	CoR	TDTA	EQTA	COTC	MOTC	CAR	NIM t-1
N of cases	131	131	131	131	131	131	131	131	131	132
Minimum	0.030	0.324	0.028	0.022	0.540	0.099	0.060	0.022	0.141	0.030
Maximum	0.060	0.628	0.066	0.062	0.653	0.146	0.132	0.118	0.276	0.060
Mean	0.044	0.511	0.039	0.034	0.606	0.116	0.093	0.102	0.174	0.044
Standard Dev	0.008	0.080	0.011	0.011	0.036	0.009	0.016	0.019	0.027	0.008
Skewness(G1)	0.121	-0.392	0.904	0.784	-0.433	0.654	-0.396	-2.833	1.547	0.135
SE Skewness	0.212	0.212	0.212	0.212	0.212	0.212	0.212	0.212	0.212	0.211
Kurtosis(G2)	-1.067	-0.653	-0.412	-0.476	-1.477	0.525	-0.015	7.950	2.578	-1.073
SE Kurtosis	0.420	0.420	0.420	0.420	0.420	0.420	0.420	0.420	0.420	0.419

The correlation matrix for conventional banks is given in table 6. When the correlation matrix is analyzed, it is seen that there is a strong relation between NIM and all the other variables for conventional banks. Especially between the TCTA ratio and NIM, there is a very strong and negative relation. This situation is related with the important place of deposits for the resources side of the Turkish Banking System. Meanwhile, the strong relation between NPL and TCTA is also the determinant of the negative effect on NIM. The data shows that the resources side must be diversified. It is also seen that the relation with NIM is strong and negative for individual loan types. The effect of total loans on NIM is the determinant of this relation right at this point.

Table 6

Pearson Correlation Matrix for Conventional Banks

	NIM	TCTA	NPL	CoR	TDTA	EQTA	COTC	MOTC	CAR	NIM t-1
NIM	1.000									
TCTA	-0.833	1.000								
NPL	0.849	-0.841	1.000							
CoR	0.856	-0.904	0.989	1.000						
TDTA	0.824	-0.859	0.710	0.764	1.000					
EQTA	0.560	-0.566	0.675	0.670	0.421	1.000				
COTC	-0.420	0.675	-0.407	-0.484	-0.394	-0.383	1.000			
MOTC	-0.488	0.590	-0.573	-0.594	-0.202	-0.444	0.626	1.000		
CAR	0.751	-0.889	0.861	0.896	0.640	0.767	-0.672	-0.743	1.000	
NIM t-1	0.976	-0.820	0.825	0.831	0.818	0.526	-0.406	-0.479	0.728	1.000

The findings of the regression for conventional banks are given in Table 7. When the findings of the model are analyzed, it is seen that few variables are included in the most significant model. While TCTA ratio is included in the most significant model, it is also seen that the EQTA ratio is included in the most significant model in the resources side. The need for diversifying the resources in banking system is also clear in conventional banking system. COTC and MOTC ratios are insignificant as were for participation banks.

It may be understood from the findings that conventional banks have a specialized structure in loan portfolio unlike participation banks. In this context, it may be understood that individual loan types may be securitized in a way that will not disrupt the balance for conventional banks. In this respect, conventional banks may use an advantage in diversifying the resources side.

Table 7

Regression Findings of Conventional Banks

	NPSM			Most significant model		
Independent Variables	Coefficient	t Test		Coefficient	t Test	
Constant	-0.015	-1.226				
TCTA	0.007	0.618		-0.005	-3.186	***
NPL	0.105	0.523				
CoR	-0.002	-0.008				
TDTA	0.029	2.025	**			
EQTA	0.040	1.374		0.055	3.810	***
COTC	-0.014	-0.902				
MOTC	-0.021	-1.249				
CAR	-0.019	-0.817				
NIM t-1	0.806	16.143	***	0.917	36.144	***
R Square	0.962			0.999		
Flat R Square	0.959			0.999		
F Test	339.843			331.019		
	[0.000]			[0.000]		
Durbin Watson Test	2.003			2.032		
Std. Error (1)	0.002			0.002		
Observation Number	131			131		

(1) Standard error of the delayed variable.

Meaningful t tests at (***) %1, (**) %5, (*) %10 levels.

With strong R Square values, both models show that success is achieved in terms of explaining the NIM and NPSM values. With the dynamic model, the autocorrelation problem was avoided. In this context, no determinations were made about the dynamic variable.

Results

The importance of retail banking is increasing in the developing banking system. Retail banking is considered as an important tool in temporary sustaining of the demand problem of the modern economic model, and it has converted the theory of banking with its structure that feeds consumption.

In the period that was analyzed under the scope of the study, it is seen that individual loan types have positive effects on the performance of participation banks. Based on the findings of the study, it is understood that the diverse loan portfolios of participation banks are made use of in the same basic profitability and risk management portfolio. In this respect, it is understood that securitizing for the purpose of diversifying resources, which might have positive effects on the performances of participation banks, may have negative effects on profitability and risk management as well. For conventional banks, on the other hand, it is seen that individual loan types have negative effects. The negative effect is fed by the total loans. It is possible to consider that low profitability of the mortgage loans may be influential on the consumer loans because of the structure of their capital assets. It might be understood that conventional banks have specialized in the management of loan portfolios and have internalized the risk-profitability balance in their loan types. It might be discussed further whether this situation may provide the opportunity of diversifying resources through securitization by conventional banks, and depending on this, it might help to acquire better performance levels. However the COTC and MOTC ratios, representing the consumer and mortgage loans, seems insignificant both in participation and conventional banks. So the effect of retail loans cannot be proven within the context of this analysis. The entire findings in this study show that participation banks have opportunities in individual banking field specifically in terms of performance indicators. The relation of this situation with portfolio management may be investigated further.

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Methodology of Islamic Economics From Islamic Teachings to Islamic Economics[1]

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Abstract: The existing literature on Islamic economics has not undergone any of the processes of verification or falsification. It is mostly restatement of the postulates as found in the Qur'an[2] or *hadith*.[3] The literature on methodology of Islamic economics is either superfluous, or ambiguous or confusing. It does not help in transforming the Islamic economic teachings into a social science. For developing Islamic economics as a social science, we must understand the primary sources in a contemporary context; formulate hypotheses based on that understanding and present these hypotheses for validation through testing. The paper illustrates the proposed methodology with some examples. For making this methodology a going concern, several basic steps would be required. The paper enumerates those steps also.

Key words: Islamic economic methodology, hypotheses of Islamic economics, developing Islamic economics as social science

JEL Codes: A13, B49, Z12

Introduction

Economics relies only on knowledge obtained through human thinking and sense-perceptions. It does not recognize any super-sensory source of knowledge and more so if it has the tag of a religion because of the general revolt against it in all social sciences. However, divine guidance revealed by God upon His

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2 The Qur'an is the book revealed upon Prophet Muhammad during 610-632 AD at Makkah and Medina and preserved by him verbatim. Its authenticity is guaranteed by God. Citations from the Qur'an indicate chapter(s) before the colon and *verse(s)* after the colon. For example: Q. 2:30 means chapter 2 and verse 30.

3 *Hadith* refers to the body of knowledge consisting of authenticated sayings, actions and approvals of Prophet Muhammad (pbuh).

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prophets, briefly termed in this paper as revelation, provides a rich source of knowledge. Some segments of the revelation deal with human economic problems. The main argument of this paper is that the existing body of knowledge under the nomenclature of Islamic economics can be transformed into a social science *by integrating human understanding of the divine sources of knowledge (the Qur'an and the hadith) to the conventional methods of theory building in social sciences*. Since Islamic economics would be based on two sources of knowledge, human thinking and divine revelation, it has the potential of enhancing our understanding of the economic problem. The scheme of the paper is as follows:

Section two gives a review of the existing literature on methodology of Islamic economics. Section three suggests a methodology for developing Islamic economics as a social science. Section four illustrates the proposed methodology. Section five presents a set of proposed hypotheses, by way of examples only, based on Islamic economic teachings. Section six enumerates some related issues for making the proposed methodology a going concern. Section seven presents defence of the proposed methodology. The last section consists of some concluding remarks.

Review of Some Main Strands on Methodology of Islamic Economics

When professional economists took over the task of developing Islamic economics as a social science, it was a welcome transition from religious scholars to professionals. The earlier contributions by religious scholars were mostly theological, explaining various tenets of Islam. The professional economists started reflecting on various technical dimensions of the subject which was yet at an embryonic stage. Methodology of Islamic economics was one of the subjects they took up for discussion and development. The main questions before them were as follows:

- What should be the appropriate philosophical approach for developing Islamic economics as a social science?
- How to integrate the Islamic legal knowledge into economics as it existed?
- What is the relationship of Islamic economics with economics?
- What shall be the criteria for accepting or rejecting Islamic theory?

Muslim economists addressed these and similar questions. However, it is unfortunate to say that most of the literature on methodology is replete with *superfluous, ambiguous or confusing* statements. In the following discussion, we shall illustrate this assertion with examples from the literature.

Examples of Superfluous Statements

Inductive vs Deductive Reasoning

An example of superfluous statements is the occupation of Muslim economists with appropriate philosophical basis for Islamic economics: Should Islamic economics follow inductive reasoning or deductive reasoning? The consensus is that Islamic economics uses both. For example, Bendjilali (2009, p. 165) says:

> Both deductive and inductive reasoning are acceptable methods of analysis in Islamic economics, and this has never posed a methodological problem for Muslim scholars in the past…

He approvingly quotes Chapra (2001, p. 38)

> Methodological pluralism may be the most suitable method preferred by Muslim scholars in the past. (Bendjilali, 2009, p.167)

By arguing that Islamic economics uses both deductive and inductive methods, Muslim scholars tend to say that it has a wider canvass and can handle economic issues with greater flexibility and dexterity than conventional economics. If we go a bit deeper in this argument we can see that the whole case for methodological pluralism is, at best, superfluous. The deductive reasoning derives various postulates and builds hypotheses from retrospection based on human reflection, social values, laws or history. For example, two postulates of economics are: "people are selfish." or "people seek wealth". These are postulates based on deductive reasoning derived from human reflection or observation.

John Stuart Mill (1806-1873) applied this method in economics.[4] An essential ingredient of this method is that the deductive postulates or hypotheses are subjected to verification. Popper (1959) developed the concept of falsifiability for natural sciences. Terence Hutchison (1964) popularized it in economics. Briefly, the idea was to confront economic hypotheses with observed reality. The hypotheses should be verified either through validation by facts or by a process of falsification. The hypothesis that is verified or which cannot be falsified becomes theory for further examination until through a similar process either

4 J.S. Mill authored A System of Logic (1843) and *Principles of Political Economy* (1848) where he pleaded for inductive reasoning and applied it to economics. His *Principles* remained a text book of economics in the nineteenth century. Its seventh edition came out shortly before his death in 1871.

it is validated or falsified. If it is continuously validated it becomes scientific law otherwise, it is modified and the whole process of validation starts all over again.

Inductive reasoning uses the method of inspection and experimentation. Based on the data collected, hypotheses are framed and presented for further examination through a similar process of validation as is used in deductive reasoning. At the end of the day, both deductive and inductive reasoning formulate hypotheses and validate them through a process of confirmation or falsification. Saying Islamic economics uses both is a superfluous statement. Economics also uses both methods.

The whole debate about inductive or deductive method regarding Islamic economics is superfluous. As Nienhaus (2013, pp. 188-89) has aptly put:

> It is not the *method* but the *object* of knowledge that counts. The social scientists should keep an open and unbiased attitude toward reality and should be willing to modify their hypotheses in light of more rational and convincing evidence. It hardly matters whether a hypothesis was originally formulated through deductive or inductive method. What matters, is a rational attitude and the humility to correct oneself if more persuasive evidence becomes available. The science should keep its rational attitude (only), *i.e.*, the readiness to challenge whatever proposition is made and to revise it in the light of convincing arguments. From an *epistemological* point of view, a scientist may choose whatever objects he or she wants to explore with whatever method.

Criteria of Islamic Economics

Another example of superfluous statements is that some writers argue that Islamic economics uses three criteria to evaluate the validity of various hypotheses: (a) the Qur'an and *Sunnah*; (b) logical reasoning and, (c) empirical testing.

There cannot be any dispute about the first criteria: evaluating a hypothesis against the benchmark of the Qur'an and *Sunnah*. However, this statement is superfluous. The hypotheses of the Islamic economics must be derived from our understanding of the Qur'an and *Sunnah*. What is the need for evaluating theses hypotheses against the same criteria from which they have been derived? How could a hypothesis be against these sources if it has been derived from them? Evaluating the hypothesis against these criteria is unnecessary. The other two criteria are the same as used by economics. Therefore, Islamic economics can adopt them without professing any innovation in methodology. The statement relating to evaluation criteria is, at best, superfluous.

Examples of Ambiguous Statements

Sources of Islamic Economics

Bendjilali (2009, p. 169) says:

> Islamic economics is distinct from conventional economics in that it accepts not only observation, testing and experimentation as a source of knowledge, but also the knowledge embedded in the Qur'an and *Sunnah*. In order to utilize the knowledge of the Qur'an and *Sunnah*, we also need other Islamic sciences, such as *Tafsir*, *Fiqh*, *Usul al-Fiqh*, etc., that helps us understand and interpret all verses and *Hadith* related to economic affairs.

It is a plausible statement that aims at achieving the best from the two streams of knowledge: using the methodology of Islamic law for defining the religious percepts and the methodology of economics for validation of hypotheses. However, the author does not explain how it would be achieved. Some examples could have added clarity to the general notion of integrating the two streams of knowledge. In the absence of any such attempt, it remains a fond hope and wishful thinking.

Besides, like several other writers, he also does not have a clear grasp of the fact that the *tafsir, fiqh* and *usul al-fiqh* literature produced in the past was time-specific. With the change of time and perspective, there is a need for an extensive review of the whole treasure of knowledge. Without this extensive exercise, we shall create situations of mismatch that leave people wondering on how they can use this literature in their real-life situations.

Integrating Islamic economic teachings with conventional economics content

Another example of ambiguous statement is what Ahmed (2009, p. 180) has quoted from Zarqa. He says:

> Zarqa (1998; 2003) suggests that the methodology for developing Islamic economics with respect to conventional economics should include the following. Firstly, adopt all the value-free positive statements in conventional economics. Secondly, include all the positive statements of *Shari'ah* that cannot be found in conventional economics. Finally, replace the normative aspects of conventional economics with Islamic values and norms.

The methodology is ambiguous: how to segregate value-free positive statements from normative statements in conventional and Islamic economics? There could be difference of opinions about the process of classification and segregation. Then, how do we replace the normative statements of conventional economics with normative statements of Islamic economics? How do we defend this act? Why are we doing this? Are we not restricting our audience to Muslims only? It would have been better if this methodology was illustrated with examples from Islamic economic teachings and conventional economics, showing clearly the formulation of the content of Islamic economics. In absence of any such illustration the idea remains ambiguous.

Examples of Confusing Statements

Nature of Islamic economics: Normative vs positive

There is confusion among Muslim economists about the nature of economic statements. They are not clear whether Islamic economics should be a positive or a normative science or both. Most of the literature on Islamic economics appears to be normative in the strict sense in which the terms 'positive' and 'normative' are used in social sciences. Some take the easier route of saying that Islamic economics is both a positive as well as normative social science. (Yasin & Khan, 2016, p. 11).

Positive economics purports to be based on facts as observed, that is "what is". As compared to this, normative economics pertains to "what ought to be" based on the specific value system, culture, religion or belief system to which the person making such a statement adheres to. Since most of the literature on Islamic economics restates the Islamic economic teachings, its overwhelming slant is towards being a normative subject. That is not an unfair approach. In fact, it should be like that, if the objective of the subject is to communicate to the world the economic teachings of Islam and not develop a social science as we tend to claim.

However, when the question of developing *Islamic economics as a social science* from the *economic teachings of Islam* comes we need to take a pause. When we stick to normative statements we tend to uphold a higher authority or value system or philosophy as a point of reference to make a judgment about the truth or falsehood or right or wrong of an idea or postulate. In case of Islamic economic teachings, this authority or philosophy emanates from God, His Apostle or His Book (the Qur'an). By itself it is a laudable position. However, we cannot take a position with respect to any statement from the divine sources that tend to disagree or refute or judge these statements. That means after stating the divine statements we come to a dead-end as far as development of a social science is concerned. These statements are there, and we must uphold and follow them.

As compared to this, in a positive social science, the standard methodology is that we observe, examine, analyze, agree or disagree with what social scientists say. Economics as a science has moved away from being a normative science to a positive science.[5] Economists now make positive statements about facts and then present these facts in a format which can be either verified or falsified. This cannot be done with the normative statements, particularly, if they are derived from the divine sources. However, if we take the positive statements from divine sources and present our *understanding of these statements* in the form of postulates, *we can test or validate our understanding* of the divine statements. The process can open the way for developing a social science from Islamic economic teachings.

This task has not even been started as such by Muslim economists. The divine sources of Islam have several positive statements as well. These statements are given in a language and format which requires interpretation and understanding. If we venture to interpret these statements and present them in a language that is amenable to validation we can make a robust start toward building Islamic economics as a social science. That is not to argue that the normative economic statements are of no relevance to us. They are quite relevant for Muslims. However, when we argue that we should develop Islamic economics as social science, in fact, we want to open the scope, approach and audience of the subject.

If we insist on keeping our focus on normative statements we would effectively de-limit the scope of Islamic economics to Muslims only. *It would become a science of the Muslims by the Muslims, for the Muslims.* It would narrow down the scope of Islamic teachings, although the Qur'an was revealed for the whole humanity and is relevant for everyone. Yet making it a normative science would create deterrence for non-Muslims. They would not like to get involved in it or take a closer look to what we present in the name of Islamic economics. Therefore, we should aim to develop IE as a positive social science and open it for the whole of humanity.

5 That is not to argue that the economists do not take normative positions. They do. They work as consultants and policy makers in governments and elsewhere and suggest actions to be taken. However, these normative suggestions are based on positive economic analysis. To the extent they do so, they are actually upholding the position that economics is a positive science. Based on the positive economic analysis, normative advice can be given. This position is valid for Islamic economics as well.

Keeping it a normative science would exclude the non-believers.

Muslim economists need to answer a more basic question: What business are they in? If they want to transform the society according to Islamic teachings, by its very nature, it is a desirable objective. But this is the work of *da'wa* (preaching). There should not be any hesitation in undertaking this work. But that has nothing to do with developing Islamic economics as a social science. Muslim preachers have been doing that work for centuries and are also busy in it at present around the globe. Muslim economists can join hands and continue that work. Proclaiming that they want to develop a distinct social science in the name of Islamic economics and then getting into the business of preaching is losing sight of the destination. This, to our mind, is the primary reason that the project of Islamic economics has not made much head-way although work has been going on at least for over four decades since 1976 when the first conference on Islamic economics was held in Makkah.

Meanings of the Shari'ah

Another example of confusion is the reckless use of the term "*Shar'iah*" to mean everything found in the Qur'an, *hadith* and *fiqh* literature. While, the texts of the Qur'an and *Sunnah* are no doubt divine in nature, the whole body of literature on *fiqh* is a human contribution. Most of the Muslim economists treat fiqh as an indispensable source of Islamic economics (see, e.g. Mozer Kahf, n.d., p.28). Without belittling the value of this monumental treasure house of knowledge, we must acknowledge that this is not divine and can be subjected to inspection and modification. Most of the literature in *fiqh* is centuries old and has lost relevance to the present times. It requires a thorough re-examination. Some Muslim economists also acknowledge this fact. For example, Habib Ahmed (2009, p. 179) says:

> While *fiqh* can be consulted in order to come up with solutions, contemporary reality in terms of human knowledge and technology cannot be ignored (Siddiqi, 2004). Doing this may not only require expanding the scope of *Maqasid al-Shari'ah* in framing new laws for the present time, but may also need revisiting the *usul al-fiqh* that has remained unchanged since the 11th century CE (Alwani, 1990).

Relationship with conventional economics

Another example of confusion is the position that Muslim economists have been taking on the relationship of Islamic economics with conventional economics (Farooq, 2013, p. 24). There have been several responses from the Muslim scholars and economists. One, reject everything that the conventional economics offers since the basic assumptions and worldview of conventional economics is different from those of the Islamic economics (e.g. Zaman, 2013; Haneef, 1997, p. 48). The idea was to develop a brand-new branch of knowledge, solely based on Islamic primary sources. Once the upholders of this point of view proceeded to do so, they found themselves using the same tools of analysis as the conventional economics does. They started grappling with economic issues considering Islamic assumptions but arriving at a similar pool of knowledge with Islamic assumptions. They assumed an ideal Islamic society where everyone was behaving according to the pristine teachings of Islam, substituting the ideal capitalist society assumptions but retaining the same format of analysis as was in vogue in the conventional economics. Besides having the blame of mimicking a well-established academic discipline, they were unable to proceed further in the absence of any real-life Islamic society. The result was an imaginary world with hypothetical and unpersuasive pool of knowledge. There was no basis to prove or disprove what the Islamic economics was offering.

The second response took the conventional economic analysis as given and incorporated the Qur'anic verses and traditions of the prophet (*pbuh*), unwittingly "reinforcing" and "legitimizing" what conventional economics was saying. Kasri (2009, p. 25) also arrives at a similar conclusion when he says, "the discipline has actually achieved little more than a re-marketing of the capitalist debt-peddling model as a pseudo-Islamic alternative."

A third response was pioneered by Monzer Kahf (nd). A crude summary of this response is that the term 'Islamic economics' is a misnomer (though he does not use this word). The pre-fix "Islamic' is unnecessary (p.19). Conventional economics studies capitalism and socialism. It can study the Islamic economic system as well. In this perspective, Islamic economics is no more than application of economic theory to Islamic economic system (p. 23). What we want to do is to study economic behavior of human beings, Muslims and non-Muslims alike, in the perspective of an Islamic economic system (p.19). The objective is to study the "is situations" and to suggest the mechanism of arriving at "ought situations" (pp. 21-22).

A deeper look in this response will show that Islamic economics is nothing but study and effort to create the Islamic economic system (p.21). Though the author has chosen the more generic expression of "study of human behavior" (p.14) and has tried to convey the message that he wants to liberate Islamic economics from the clutches of religiosity, yet at the end he is arguing for creating an Islamic economic system. By his definition, he wants to suggest that everyone, Muslims and non-Muslims alike, can study this economics as it does not deal exclusively with any religion (p.17). But this impression is nullified when he concludes his argument. He wants to create an Islamic economic system and the study of human behavior in that system would constitute Islamic economics, although it would be a sub-set of conventional economics using same tools of analysis as conventional does. How does this definition and approach make Islamic economics a universal science? It would not interest non-Muslims to study a subject that aims at creating (to their belief) 'an offensive system'. Even more significant is the fact that Islamic economics is reduced to the work of '*da'wah*'. Further, studying Islamic economic system is an impossible task. It does not exist anywhere and is not likely to come into being in foreseeable future. Not only this, it is not even known what are the minimum conditions that will make a system Islamic economic system. Even if we say that the task before us is to create such a system, we do not know if we have achieved that objective. Moreover, there is no clue how he likes to develop a social science from application of economic theory to a hypothetical economic system?

A fourth response which seems to be more moderate pleaded for using the conventional economics where it does not conflict with the Islamic worldview (See, e.g. Farooq 2013, p. 31). Habib Ahmed (2009, p. 180) illustrates the fourth and moderate response as follows:

Chapra (2000, 129) points out that Islamic economics can benefit from the knowledge produced in conventional social sciences in general and economics in particular. Similarly, Ahmed Yousri (2002) also maintains that as long as concepts and principles of conventional economics do not contradict Islamic principles, they can be adopted in Islamic economics.

At the micro-level, experimental economics can verify various assumptions of Islamic economics, especially those concerning values and ethics. Furthermore, many recent empirical studies show that cultural variables and values can be measured by using appropriate proxies. For example, Guiso *et. al.* (2004) use proxies for social capital in an empirical work on financial development. Similarly, Knack and Keefer (1997) and Calderon *et el.* (2001**)** study the relationship between 'trust' and a variety of economic variables. At the macro-level, simulation models incorporating the beliefs and norms of Islamic behavior can be worked out in order to see their impact on economies. Two recent papers that use simulations to see the impact of Islamic values and principles are Al-Suwailem (2005) and Ahmed (2006).

We think the first two responses were fallacious. In the first case, since there is no ideal Islamic society in existence and there is none in sight in near future, there is no point in hypothesizing on the basis of this concept. The second response is trying to seal the conventional economics with Islamic approval, which is uncalled for. It will not add to or subtract from the creditability of conventional economics, nor will it add anything to the value of Islamic point of view. (p. 181)

We think that the fourth response is more balanced than the other responses. Let us accept that in its core, most of the Islamic economic principles and assumptions about human behavior are in line with capitalism; e.g. private property, free market economy, welfare and regulatory role of the government, and objectives of full employment and social security net, etc. Therefore, most of the conventional economic analysis can fit quite well into the Islamic framework. Since there is no ideal Islamic society in existence, the economic behavior of most of the Muslims is like non-Muslims. There is no reason to have different assumptions about human behavior. Thus, most of the conventional economic analysis would apply to the Muslims as well. We need not quote Islamic injunctions to 'Islamize' the conventional economics.

Validation procedure

Another area of confusion is regarding Muslim reaction to the conventional economics methodology of verification or falsification. Some Muslim economists thought that verification or falsification of Islamic postulates would expose the divine ordinances to human verification or falsification, which would be synonymous to committing a sacrilege. Therefore, the methodology is not suitable for Islamic economics. For example, Addas (2008, p. 29) writes:

> To be sure, Islamic economists have little interest in the *falsificationism* or *verificationism* criterion to evaluate the efficacy of economic theories: they scrutinize their validity just from an Islamic perspective anchored in a set of beliefs and rules derived from *revelation*. Muslims would *falsify* or *verify* what is to be considered as true knowledge or otherwise on that criterion alone. In this sense, the methodology of Islamic economics is based neither on 'falsification' nor on 'verification'. It uses both.

It is a highly confusing statement. It mixes up divine ordinances with their human interpretation and understanding. To say Islamic economics would falsify and verify theories on basis of revelation only does not recognize the fact that the divine ordinances are only a few in number and cover only some of the key situations in social reality. Functioning of economies and markets and the related human behavior, in most of the cases, remains within the domain of human reasoning and understanding. Muslims cannot find explicit criteria in the divine texts for verifying or falsifying of most of the hypotheses in economics.

Objective of Islamic economics

There is also confusion about the primary objective of Islamic economics? Why do Muslims want to develop Islamic economics as a social science when already a body of knowledge in the name of 'economics' exists? They are not clear. A popular argument is that they want to develop Islamic economics because economics is a positive science and studies the conditions as *they are* and not as *they should be (f*or example, Bendjilali, 2009, p. 168; Farooq 2013, p. 27). Bendjilali supports Chapra (2000) that the empirical data should be collected of the real condition of Muslims around the world so that a strategy can be devised to change the present state to the desired state.

Nienhaus (2013, pp. 196-197) has rightly pointed out that despite all the lip-service to fill the gap between "what is" and "what ought to be", Muslim economists have not produced any model for transition from the existing situation to the desirable situation. Similar observations have been made by Farooq (2013, pp. 27-28). Until that is done, the whole project of transforming the existing economies into Islamic economies would remain unfinished.

Scope of Islamic economics

Still another area of confusion is about the scope of Islamic economics. For example, Bendjilali (2009, 169) says:

> As far as the scope of Islamic economics is concerned, it should study all economic phenomena throughout human society, whether that society is Islamic or not, because Islam is a universal religion, and as such draws our attention to relationships and variables applicable to all human behavior and not just that confined to Muslims.

It is a tall order. It takes us to the basic question: The economic phenomenon around the globe is being studied by economics. In what respect are we going to make a difference if we study it under the banner of Islamic economics?

The above discussion shows that Muslim economists have not been able to present a generally accepted approach toward methodology of Islamic economics. The distinctive feature of Islamic economics is that it pleads for benefitting from revelation as a source of knowledge. But the format of the revelation is not that which is generally accepted for a social science like economics. For this purpose, Muslim economists need to develop a distinct approach which enables them to integrate the knowledge received through revelation with the knowledge acquired through observation, experimentation, and human thinking. To this subject, we now turn in the following section.

The Way Forward

Economics is a social science that has evolved over centuries. It is based on the knowledge derived from human thinking, observation, experimentation and analysis. It does not accept any super-sensory source of knowledge as valid. The distinctive feature, and the very rationale of Islamic economics, is that it aims at integrating the human knowledge with the divine content. The idea is that God provided a rich source of knowledge through His apostles. God granted all His apostles the same basic truths such as oneness of God, a list of righteous deeds, resurrection after death and a Day of Judgement. Within this general framework of guidance, each apostle was given a set of rules and dos and don'ts according to the socio-economic development of each age. In the series of God's apostles, Muhammad (pbuh) [570-632] was the last, after whom no apostle has been sent by God. He was granted the final guidance which is preserved verbatim since his time and is available in the form of Qur'an. The Qur'an contains the last word of God and contains guidance on the entire spectrum of human life, including economic matters.

The basic idea of developing Islamic economics as a social science is to benefit from the guidance provided by God in His final book, the Qur'an, and from the practical example of its practice by the Prophet Muhammad (pbuh) himself, called his *Sunnah*. The work done so far in the name of Islamic economics is a restatement of the economic teachings of Islam. The task before Muslim economists is to transform the guidance contained in the divine sources of Islam into a social science. We have discussed the methodology of theory building in Islamic economics elsewhere (Khan, 2013; 2014-a; 2014-b; 2016). In the following paragraphs, we shall recapitulate our ideas on the subject just to complete the argument.

Islamic economic teachings, as found in the primary sources of Islam and as presented in the literature on Islamic economics are sets of rules and regulations dealing with economic aspects of life. They are prescriptive by nature and are to be followed as guidance for leading everyday life. However, these teachings of Islam contain a wealth of material, not yet properly focused by Muslim economists; have seeds for developing a social science in the name of Islamic economics. The difference between *economic teachings* and *economics as social science* is that the former is normative and prescriptive and aims to transform the human behavior and the latter are positive and objective and focus on making predictions about future outcomes. Since the source of Islamic economic teachings is divine, there is no question of applying the standard methodology of verification and confirmation on these teachings. However, *human understanding* of these teachings can be subjected to the process of verification and confirmation as followed by economics.

The idea is that Muslim economists should understand the texts of the primary sources of Islam and present their understanding in a language and format which is amenable for verification or falsification. This is the standard procedure for developing knowledge in economics and other social sciences.

The advantage of resorting to economic teachings of Islam for formulation of hypothesis is that it can cut short the human thought process. It is possible that human reason and thinking also leads us to the same hypotheses as the guidance from the divine sources would. But the process of arriving at a hypothesis through human reason only may take much longer and remain exposed to human errors. However, a hypothesis derived from the divine guidance is likely to cut-short the journey for arriving at the same conclusion and reduce the hazards of human errors considerably. For example, human thinking has now arrived at the wisdom and sagacity of more equitable distribution of income and wealth after centuries of thinking, and committing errors and omissions (See e., g. Stiglitz 2015). But this conclusion could be reached in a much shorter span of time and with minimal mistakes, had the humanity availed the guidance from divine sources. More examples can be cited to illustrate the point that the economic teachings of Islam have the potential of helping the humanity in finding robust solutions to economic problems. By studying the economic teachings of Islam and transforming these teachings into a social science, frontiers of economics can be expanded.

We propose the procedure for transforming the Islamic economic teachings into a social science, briefly, as follows:

Step1: Develop a clear understanding of the Islamic economic teachings in the context of present day social reality, without discarding the interpretations of divine sources by earlier scholars. However, an understanding of the texts that considers the contemporary reality is essential. It would also require extensive use of innovative thinking (*ijtihad*) to see and understand the relevance of the divine texts to the present age.

Step 2: The human understanding of divine sources of Islam developed at Step 1 above should then be transformed into hypotheses. Several injunctions can become one hypothesis or one injunction can lead to formulation of several hypotheses.

Step 3: The language and format of the hypotheses should be such as is amenable to validation though processes of verification or falsification. We have given examples of 25 such hypotheses in two of our papers (Khan, 2014-b; 2016). These examples can stimulate thinking of Muslim scholars for further work in this direction.

Step 4: Through an extensive process of consultation, discussion, verification or falsification, the hypotheses developed should be tested. Data should be collected from the field to confront the hypotheses. The objective would be either to confirm what the hypotheses claim or to falsify their outcomes. In any case, if the hypotheses are confirmed or cannot be falsified by real-life evidence, they would be validated. [See Fig 1 below]

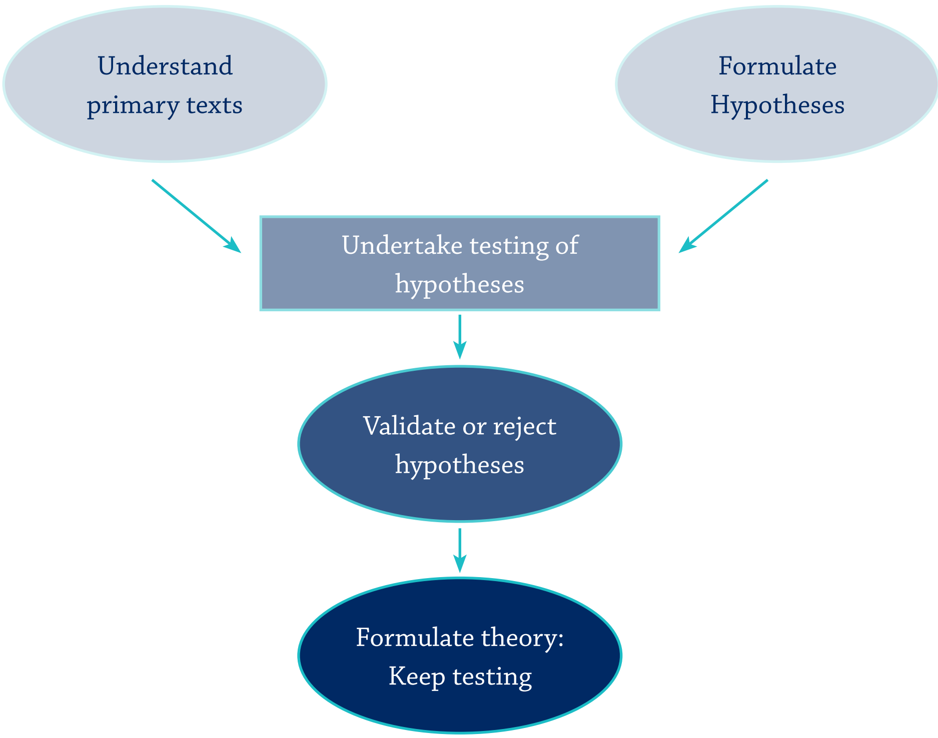

Figure 1. Theory Building in Islamic economics

Step 5: The process of theory building would continue after the initial validation of a hypothesis. The hypotheses would continuously remain under examination and people would keep confirming or falsifying them. Only after repeated trials for extended periods, the hypotheses would be accepted as theory.

Step 6: The theory of Islamic economic thus built would remain under examination in future. If it cannot be refuted, it would become the economic law.

In the process, at each stage of testing, conditions and qualification would be added to the initial hypothesis and theory. This is the standard methodology used by economics. Islamic economics would also follow this methodology.

So far Muslim economists have been diffident in using this methodology as they were reluctant to confront the divine teachings of Islam to the stand ARD procedure of confirmation or falsification. They even openly rejected such a procedure. But our proposal is that the divine *teachings of Islam need not be subjected to the procedure of testing and confirmation*. Muslim economists should develop an understanding of the divine teachings; formulate hypotheses based on this understanding; and subject those hypotheses to confirmation and falsification process. They would not be exposing themselves to any sacrilege.

Illustration of the Proposed Methodology

Positive Economic Statements of the Qur'an

The first step for developing Islamic economics as social science is to concentrate on positive economic statements of the Qur'an and *hadith*. We present below some examples of these statements from the Qur'an. Although these statements have normative implications yet they provide basic material for developing Islamic economics as a social science. A similar exercise can be done by focusing on positive economic statements of the *hadith* literature.

Prosperity and misery at macroeconomic level

The Qur'an discusses prosperity and misery in general terms. It refers to deeper, imperceptible and long-term currents of events taking place in the cosmos because of human actions and under the will of God. These currents affect the process of wealth creation in ways that cannot be explained easily in a simple cause-effect framework. The factors of production combine in the production process and create wealth. Over and above the visible cause-effect relationship of the factors of production, there are moral laws which influence the ultimate result. These laws operate in response to certain traits of human character and behaviour which influence the state of prosperity and misery. A normative change in human behaviour can transform misery into prosperity and vice versa. The precise mechanism through which the laws operate is yet unknown because the meanings and interpretations of the Qur'anic texts on the subject require further thinking and deeper understanding.

The Qur'an visits the subject of human prosperity and misery at various places to draw attention toward God's almightiness and invites human beings to adopt the path of righteousness. These statements address communities and societies as well as individuals. For example:

- Economic deprivation and prosperity are states of trial from God. [Q. 2:155, 7:130, 7:168]
- Following the divine guidance brings material prosperity. [Q. 5:66, 7:96, 16:39, 24:55, 72:16]
- Material prosperity accompanied by unethical behavior is short-lived and ends in misery. [Q. 6:6, 6:42-44, 7:96, 22:45, 22:48, 30:41, 34:15-17].
- Transformation of economic well-being of a community into economic deprivation and vice versa is a consequence of changes in the ethical behavior of people. [Q. 8:53, 13:11].
- Unethical behavior by majority of the people brings economic misery and transforms prosperity into misery. [Q. 11:116, 89:15-20]
- Persistent ingratitude by a community at macro-level transforms prosperity into poverty and brings insecurity in the long-run. [Q. 16:112]

Prosperity and misery at microeconomic level

Human beings require for their survival material resources such as income and wealth and non-material resources such as good health, peace of mind, healthy children, knowledge, skills, social respect and harmony, and safety and security, etc. The Qur'an terms these resources as "*rizq*". There are several positive statements relating to distribution of *rizq* among individuals. For example:

- God has absolute power in distribution of the *rizq*. [Q. 2:212, 3:27, 3:37, 13:2629:62, 30:37, 34:36, 34:39, 39:52, 11:6, 29:60, 42:19]
- Expression of gratitude for God's bounties leads to increase in *rizq*. [Q. 14:7]

- God deprives income from *riba* of all blessings. [Q. 2:276]
- God has created all human beings unequal to enable them create civilizations. [Q. 43:32]
- Spending on others (*infaq*) *is* a loan upon God who promises to return it with manifold increase. [Q. 92:18-19, 2:195, 2:219, 2:245, 17:26-27, 25:67, 47:36-37, 57:11, 57:18, 64:17]
- *Infaq* is a vehicle for an increase in the wealth at individual and social levels. [Q. 2:261, 2:265]
- *Infaq* accompanied by God consciousness (*taqwa*) and ethical values lead to a life of ease while miserliness, arrogance and unethical behavior lead to a life of hardship. [Q. 92:5-10]
- Compliance with divine injunctions while being God-conscious opens doors of ease. Reposing trust in God during hardship brings unexpected financial help from God. [Q. 65:2-3]
- An attitude of humility and willingness to mend past errors, termed as repentance (*tauba*) by the Qur'an, opens door-ways for material prosperity. [Q. 11:3, 11:52, 71:10-12]
- Patience in bearing adverse changes in economic well-being is a foreboding of increase in income and wealth. [Q. 2:155, 94:5]
- God determines the *rizq* keeping in view an individual's needs. God also considers the requirements of social balance while distributing income and wealth. [Q. 42:27]
- Ethical behavior in economic dealings leads to prosperity. [Q. 72:16]
- Some forms of unethical behavior lead to financial hardship. [Q. 89:15-20]

Both sets of statements regarding economic prosperity and misery are general indicators of the way the wealth and income are distributed by God among individuals and communities. However, the exact mechanism of how God implements His plan is yet unknown to us.

From Positive Economic Statements to Islamic Economics

Second pillar of the strategy for developing Islamic economics as a social science is to proceed from the positive economic statements of the Qur'an and *hadith and* transmute theological statements into a social science. For this purpose, we can adopt the same methodology as that of the conventional economics. However, we should take a fresh look over the positive economic statements of the Qur'an and *hadith*. The injunctions of the Qur'an and *hadith* are divine and immutable but our understanding is not. We should be willing to formulate human understanding of the divine texts in the format of hypotheses which are amenable to validation and falsification. We have discussed the methodology of developing Islamic economics as a social science from the positive economic statements in the Qur'an and *hadith* elsewhere (Khan, 2013; 2014; 2014-a; 2014-b; 2016). At this place, we shall only present a summary of these discussions. For developing Islamic economics as a social science, we should proceed as follows:

(a) We should take economic statements of the Qur'an or *hadith* as immutable and unchangeable. Since each of the Qur'anic verse or *hadith* dealing with divine economic laws can be interpreted in more than one way, our objective should be to understand the cause-effect or operational process of these statements. The challenge before us is to arrive at interpretations which can be tested and verified empirically or rationally. *It is not that we need to test the Qur'anic* or *hadith statements. It is the human interpretation and explanation of these statements that we need to test empirically or rationally.*

(b) Based on our understanding of the statements in the Qur'anic or *hadith*, we should develop hypotheses that propound to make some predictions. There could be several hypotheses for each statement or one hypothesis from several statements. The form and content of the hypotheses could change with passage of time as our understanding evolves. We should present various hypotheses in a format which can be either verified by empirical testing or cannot be falsified by facts and rational thinking[6].

(c) The hypotheses should be available for testing and verification in varied conditions. The results of hypotheses testing should be widely published inviting the world community of knowledge to examine and comment on this research.

6 It is interesting to note that the methodology of verification presented by Karl Popper (1902-1994) under the generally accepted thesis of falsification has its origins in the Muslim theological thought. Iqbal (p.102) says: "It was, I think, Nazzam (775-845) who first formulated the principle of 'doubt' as the beginning of all knowledge. Ghazali (d.1111) further amplified it in his 'Revivification of the Sciences of Religion' ('Ihya al-Ulum al-Din), and prepared the way for 'Descartes' Method'."

After years of research and introspection, operation of some of the moral laws would be discovered and we shall be able to present our understanding in a format that can be used in wider economic analysis. The suggested procedure will enable Islamic economics extend frontiers of the conventional economics. However, it will have a distinct research agenda for itself and have no dispute with the conventional economics. Both social sciences can complement findings of each other and live side by side. One of the contributions of Islamic economics to human knowledge would be to develop a methodology for making the Qur'anic economic laws manifest in human situations. It will add a new dimension toward understanding and analyzing the human economic problems.

Examples of hypotheses based on Islamic economic teachings

We have illustrated the above procedure in two of our earlier papers (Khan, 2014-b; 2016). These papers explain in greater detail the steps to be taken for developing theory of Islamic economics. In this section, however, we shall present some examples of how the procedure discussed above would be applied.

Hypotheses on Riba

The Qur'an declares *riba* as illegal (Q. 2:274-281). However, it does not say in so many words if the commercial interest in vogue is *riba* or not. Classical Muslim religious scholars, almost unanimously, declared that all forms of interest, including, commercial interest are forms of *riba* and must be avoided. Based on this interpretation of the term *riba*, the entire movement of Islamic finance was launched during the last three decades or so which has now bloomed into hundreds of institutions. However, in actual practice, the Islamic financial institutions have adopted methods and procedures so similar to interest that it is difficult to tell if they have actually succeeded in eliminating *riba* from their transactions. Because, of this controversy, the question of definition of *riba* remains alive. However, instead of going to definition issue and remaining locked there for all times, there is another way of understanding the Qur'anic injunctions on *riba*. The Qur'anic Verse Q. 2:276 clearly says that God deprives *riba* of all blessings (*yamhaqu Allah al-riba*). One method of developing theory of *riba* in Islam could be to develop understanding of the Quranic expression of '*yamhaqu Allah al-riba*" in the context of our age. The understanding of this expression can lead us to several hypotheses, which can be tested and can confirm our understanding. Some examples of the hypotheses are given below:

Hypothesis 1: Average rate of return on capital invested as interest-bearing loans tends to decline in the long-term, other things remaining the same.

Hypothesis 2: Aggregate value of assets of money-lenders whose major source of income is interest earned on consumption loans which tends to decline in the long-term, other things remaining the same.

Hypothesis 3: Average rate of return on the cost of goods sold on deferred payment basis that includes interest in the sale price on the delayed payment tends to decline in the long-term, other things remaining the same.

Hypothesis 4: On an average, development projects financed by international donors as interest-bearing credit lead to lower than planned rates of net present value and internal rate of return, other things remaining the same.

Hypotheses on Infaq

We can take another example. God has emphasized the importance of spending for His sake on other people, relatives and community. This is expressed in the generic term '*infaq*'. At various places in the Qur'an, God has persuaded people to undertake *infaq* and has promised rich rewards both in this world and in the hereafter. In this world, God has promised to replace the money spent as *infaq* or to multiply it in future. Based on such verses of the Qur'an we can understand that *infaq* leads to prosperity and peace in this life as well. Assuming this understanding of the verses on *infaq* is persuasive, some of the possible examples of hypotheses could be as follows:

Hypothesis 5: Spending from collective receipts of obligatory *zakah* at the national level leads to increase in employment level at macro level through multiplier effect of the increased consumption of the recipients in the long-term, other things remaining the same.

Hypothesis 6: Systematic and sustained charitable spending by an individual or a business firm has a positive correlation with gross income or economic growth of the giver, other things remaining the same.

Hypothesis 7: Regular and systematic payment of *zakah* by an individual or a business firm enhances the volume of *zakah* obligations of the giver in successive years through increase in income and wealth liable for *zakah*, other things remaining the same.

Following the above procedure, we have tried to formulate hypothesis on certain economic subjects such as gratitude (*shukr*), repentance (*tauba*), God-consciousness (*taqwa*). Examples of various hypothesis on these subjects can be referred to in our two papers cited above. The crucial point is that these are only examples of application of the methodology suggested in this paper. There is nothing sacrosanct about the format, language and even the understanding of the Qur'anic text on which these hypotheses have been formulated. In actual practice, if Muslim economist find this approach plausible, they can take these hypotheses or formulate more such hypotheses for further examination through the process of confirmation and falsification suggested above.

Some Related Issues

Developing Statistical Infrastructure

Fourth pillar of the strategy for developing Islamic economics as a social science is to develop statistical infrastructure for collecting and analyzing the data. Most of the required data would pertain to socio-economic behavior of people. In some cases, testing would require information on long-term basis. That should not discourage us. There are traditions of long-term research in other disciplines. For example, in health sciences, sociology, psychology and anthropology data are collected over long-periods on large numbers consisting of a variety of individuals, situations and assumptions. Information collection continues until the researchers can conclude on certain trends and hypotheses. Since the economic subjects in the Qur'an and *hadith* also deal with human behavior, in some cases data would be required for representative and unbiased samples (preferably for large numbers) over extended periods of time. In most cases, five years would be too short a period. We think that process of hypotheses building should take place at levels of institutions such as universities, academies and research institutions which should collect and analyze data over long periods of time.

Relationship with Conventional Economics

Fifth pillar of the strategy for developing Islamic economics as a social science is to understand clearly and precisely its relationship with conventional economics. Islamic economics has no dispute with it as it does not replace, or modify it. The two disciplines have their own subject matters and can develop side by side. The conventional economics studies the economic problem of man from purely material and physical angle. It focuses on the behavior of individuals, markets and organizations regarding resources produced, distributed and consumed. Islamic economics studies the economic problem of man regarding ethical and spiritual principles. Both these planes of discussion are complimentary and not mutually exclusive. While the invisible hand of markets determines supply and demand, the Invisible Hand of God acts in an over-arching manner and influences the operations of these very markets by influencing human minds and thoughts. God implements His grand scheme of distribution of income and wealth through markets and organization. Economics does not study this phenomenon. Islamic economics purports to do that. While doing that, it attempts to understand the moral laws of God in operation over and above the market laws. Thus, the two disciplines have no conflict. They only complement each other.

If we must develop Islamic economics as a social science, and we think it is a potentially feasible enterprise, we should not attempt to modify conventional economics from an Islamic perspective. Instead, we should study conventional economics as it is but develop Islamic economics as a social science from its theological roots. It should not be an attempt to transform conventional economics into Islamic economics. We can use the methodology of conventional economics without any reservations. Islamic economics should not feel shy of adopting and using tools of analysis used by conventional economics or other social sciences. These tools are available in the present form after centuries of thinking and experimentation and are common heritage of the humanity to which Muslims had also contributed in their heydays. Islamic economics should make use of that heritage freely.

Focus of Islamic Economics

One of the pillars of the strategy for developing Islamic economics as a social science is to define the focus of Islamic economics clearly. Islamic economics addresses the whole of humanity. It is not a science that deals with the problems of Muslims only. Its study does not require faith in Islam nor does it require an Islamic society for developing its knowledge-base. Its postulates, hypotheses, theories and laws are valid for all societies and for all people. Islamic economics should come out of the problem of conceiving its postulates in the context of Islamic economy since it does not exist anywhere in the real world. Instead, it should deal with problems of the economies that exist in the real world.

In Defence of the Proposed Strategy

Since the strategy discussed above departs significantly from the path adopted by contemporary Muslim economists we think it necessary to present some thoughts in its defence.

(a) Qur'anic verses 2:258-260 refer to three incidents which indicate God's preference for empirical evidence. Verse 3: 137 invites people to '*go around the world and see the fate of those who rejected the Truth*.' Verses 10:36 and 53:28 say that '*conjecture can never be a substitute for truth*.' Verse 17:36 advises people '*never to concern themselves with anything about which they do not have sure knowledge*'. These verses clearly indicate that all knowledge must be supported by indefensible evidence.

(a) Without breaking from the past, the methodology opens new opportunities for having a fresh look at past understanding of the divine sources. The method owns and adopts the divine sources as supreme, which makes it a continuum of the past. At the same time, it permits people of the present age as well as future generations to review and reinterpret all that the past intellectual efforts have retained for us. In that respect, it opens immense possibilities for creating new knowledge.

(b) The strategy adopts scientific method developed by social sciences over centuries of thinking and experimentation. It does not discard gains of the scientific knowledge. It only builds upon those gains. It adopts the now generally accepted method of formulating and testing hypotheses considering empirical evidence. It applies the concept of falsification of hypothesis which would not be possible if we remain confined to *Islamic economic teachings* because venturing to test those teachings may be construed as blasphemous in the first place. The methodology goes a step further from Islamic economic teachings. It applies scientific method to *human interpretation* of the divine sources, avoiding all conflict with religious elite and social scientists. The method displays a unique situation of humility. On the one hand, it respects the divine sources and all that has been presented by religious scholars of the past. On the other, it adopts the scientific method developed by the social scientists. Thus, with the humility and willingness to benefit from both streams of knowledge, it tries to integrate human understanding of the divine sources with empirical testing of that understanding. Simultaneously, the method avails of the freedom to have a fresh look on the past religious thought. It provides a sort of dynamism to the religious thought and may become a vehicle for emancipating the *fiqh* knowledge from immobility of the past centuries[7].

(c) The method opens new vistas of interaction with other faiths. Once we can demonstrate the utility of this method we remain open to apply it to divine sources of other faiths like Judaism, Christianity, Buddhism, etc. It will provide corridors of hand-shake with the people of other faiths. The current environment of 'Islamophobia' would give way to new methods of borrowing from other faiths for Muslims as well as for people of other faiths. It will provide a forum for positive and fruitful inter-faith dialogue.

(d) There is a realization among economists and finance professionals to bring ethics into mainstream branches of knowledge[8]. But aversion of getting sucked into a religious framework creates barriers against incorporating ethics in economics and finance. The method allows economists and finance professionals to embrace education and teaching of ethics without getting into the business of professing any specific faith.

Concluding remarks

In this paper, we have argued that the work done so far under the nomenclature of 'Islamic economics' mainly consists of *Islamic economic teachings*. It cannot be termed as *Islamic economics* because it does not have theory which can make predictions about the future. The Islamic economic thought has not been recognized as a social science by the wider academic community in the field of economics. One of the reasons for this is that the Islamic economic thought consists of material taken from the intellectual heritage of Muslims without much review and modification. Most of it pertains to pre-modern age and is about one thousand years old. The society has moved on since then. New modes of production, new methods of wealth creation and distribution, new problems, issues and concerns have emerged. A knowledge that discusses a thousand years old issues cannot attract attention of the contemporary world.

It does not mean that the original aim of developing Islamic economics as a social science was baseless. It still has a merit. The knowledge received though

7 It is important that the Muslim scholars feel nostalgic about *fiqh*. They want to go back to the *fiqh* as it is, without any major fresh thinking. They think that the revival of Islamic economics should be made by anchoring the subject on the *fiqh* which is suffering from antiquated ideas for the last six centuries. See for a recent example introductory chapter by Kizilkaya (2015, 9).

8 See for example, Maghrebi et el (2016, 49); Lagarde (2015); Stückelberger (2012, 454); Schwartz and Carroll (2003, 512);

revelation can guide the humanity in solving the economic problems. However, for making an effective contribution, human understanding of the primary sources of Islam should be stated in the language and format of hypotheses which can be tested for validity. A subsequent process of detailed validation should follow to conclude on the understanding of the primary texts. If the hypotheses are validated, they would constitute the hard core of Islamic economics. If they are not validated further thinking and research would be necessary to refine understanding of the primary texts. This would be an ongoing process.

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Economic Sociology of Islam According to The Risale-i-Nur

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Abstract. Since economic policies and administrative regulations cannot be differentiated from their own material circumstances and sociological basis, a multidisciplinary analysis is conducted over economics, sociology and related Islamic jurisprudence in order to add value to solutions for some problems in Islamic economics. Particularly as a contemporary reference with its methodological originality, Risale-i Nur Collection is prominent in setting up of economic principles with their sociological basis from the holy Koran. Our argument is that since sociological basics of Islamic economics are valid and pervasive, its results are more congruent, logical and beneficial in providing human happiness and easing burden of worldly life. Therefore, in comparing western sociology that centralizes worldly life in primer focus by subjugating everything that can serve material progress and capital accumulation as means of production or productive relations, with *İslamic* sociology that takes world only as a temporary place but worthwhile to the extent that it preserves life of the hereafter by subjugating whatever exist as creature means relation of which should be based on Divine consent.

Keywords: Islamic Economics, Sociology of Economics, Socio-economic principles

JEL Codes: Z12, B29

Introduction

As a social science, economics is defined as the assessment of specific theories and concepts by analyzing the knowledge of economic preferences of people and societies to meet their ever-evolving unlimited needs with limited resources. Human needs and preferences may undoubtedly vary according to the social and cultural values of the people and it is not possible to explain economic preferences to the market mechanism itself because of their differing levels of consciousness, perceptions, beliefs and cultural values behind their economic behaviors.

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Economics is assessed by considering normative and objective as well as subjective parameters. At this point, the intersection of economy with sociology is inevitable. For this reason, it is important to be able to evaluate the sociological bases of the economy, the economic man's preferences, and the social factors that trigger the perceptions, social conditions, cultural values and behaviors.The normative dimension of the economy, which is within the scope of sociology as it is in every scientific branch, has differing content and dimension. Terminologies such as households, entrepreneurs, producers, consumers, buyers, sellers, workers and employers constitute the scientific objects of examination of sociology as much as it is of the economics. This situation is similar for modern economics and positivist sociology as well as for academic studies and socio-economic practices in Islamic countries.

However, the economic solutions in the Muslim countries have not been relieved yet from the influence of the western central capitalist countries in terms of system, policy and institutional practices. Many approaches, techniques, principles, and policy analyses presented as Islamic economics are in fact neither interpreted as Islamicized versions of modern economics nor pure and unique Islamic paradigms. In order to solve this problem, the relationship between the Islamic economics with other neighboring areas as a scientific discipline must be formed.

One of the tasks that need to be done in this context is the analysis of Islamic economics, in terms of sociology of economy and socio-economic point of view. However, when an attempt is made in this way, it is important that modern sociology, which is a product of western philosophy, should be analysed according to social principles of Muslim communities and approaches in a fully Islamic perspective. Since an independent scientific discipline under the name of Islamic sociology has not yet come to fruition, it is necessary to refer to one of the religious artifacts and to apply the sociological principles and evaluate it with Islamic perspectives.

It is not yet clear how analytical approaches other than modern economics shown as Islamic financing methods are more blatant in the scientific discipline as well as the legal approaches of the sharia the Islamic jurisdiction. For this reason, it is beneficial that Islamic economics and its relationships with other neighboring disciplines are examined to understand what kind of contribution Islam can deliver to economics and sociology. Risale-i Nur is prominant in making evaluations in terms of Quranic commentaries. The reason for this is the originality of the Risala in style, content and effect that are rare and are not encountered in other contemporary works. Most of the works of Risala are written under captivity and in the First World War. Every subject was discussed from the point of view of extracting meanings of the universe, and all matters of the creation were evaluated from the perspective of omnipresent creator and temporary transient creatures. For example, it is underlined that the most important problem of the human being is acquiring sustainable happiness for both the world and the hereafter in terms of profitability of life span capital and getting rid of the hell or extinction. Without making analysis similar to modern economic theories and not considering the accumulation of material capital, the necessity of using life capital as the most valuable scarce resource for optimal outputs and to have a chance for eternal life are being evaluated. Therefore, while focusing on a person's possibility of winning the life of the Hereafter from the world's life, Islam is trying to put forth a miraculous aspect that life can be spent more happily, prolific and wise.

While analyzing the point that the modern economic theory requirements can only be met with an approach to managing limited resources for the unlimited needs of the worldly life, the Islamic economy considers the life of the world as well as the life of the afterlife at the same time, taking the life of the world as one of the sources for both of the worlds. All beings in the temporary world are regarded as written treasures of God's names waiting to be read in the form of a divine letter.

The basic approach in the interpretation of the Risale-i nur is its manner to treat the objects of examination of all scientific disciplines without distinction according to any scientific discipline, and without separating the sciences from religious sciences (Nursi, 1960c) It is alleged that genuine humanity and exalted civilisation can be obtained with true and sincere faith. Therefore, all scientific disciplines are regarded as a key to the enlightenment and ingenuity of human beings. The twenty-four hour lifetime that is given to human every day is treated as a scarce capital which is regarded as an opportunity to gain eternal bounties and gardens as much as the worlds. In this approach, it is of course important to take into account the social conditions, group psychology and social values of the people in optimization of meeting requirements of the belief. For this reason, the examination of the sociological bases of the Islamic economy is of great importance in terms of the maturation of the Islamic economics.

Methodology

Descriptive and relational methods of logical analysis are used in our research. In addition, literature review is conducted through Islamic economy, behavioral economy and sociology of economics. The main purpose of this study is not to study in detail the sociological dimensions of the Islamic economy. This would require a comprehensive analysis and evaluation that can only be a subject to study of a book. The main purpose here is to show that the sociological bases of the Islamic economy can be demonstrated and be proved to be different from the modern sociology on which our modern economics is based.

The basic assumption of our research is that human being is a social creature and sociological considerations surely affect an individual's economic behavior. A second assumption is that religious values and practices are not merely metaphysical and psychological, but also reflect in communities by effecting sociological and economic factors and outcomes at the same time. Our basic theory is that Islamic principles are sociological sub-structures that can provide solutions to current economic problems. Accordingly, our research questions are as follows:

1. *Can Islamic economics and principles be analyzed from a sociological point of view?*
2. *Is it possible for the Risale-i Nur to contribute to the sociological bases of the Islamic economy in terms of being a contemporary work in Turkey?*

In order to be able to find the answer to the above questions, firstly the research problem is determined by examining whether there is a problem related to the subject; the sociological bases of the economy are set in the context of relationships of modern economy with sociology; the relationship between economy and religion culture is discovered; how the sharia and the economy are positioned is evaluated; whether there are sociological bases of the Islamic economy, and finally, in the context of Risale-i Nur, whether the research questions can be answered after the evaluation of economic principles in Islam with sociological approach is evaluated.

Research Problem

In our study, it is investigated whether the economic behaviors are affected by sociology and whether it is possible to solve economic problems with sociological analysis from the Islamic perspective. The main point of our research is that Islamic societies tend to be more dependent on systems, approaches and policy packages and institutional structures that are the products of Western sociology, and that Islamic countries seem to be environmental communities to the producers of western central capitalist countries that is the capitalism.

While the Islamic economy studies which can be evaluated within the scope of searching alternative systems which could remove the destructive effects of capitalism and socialism from the 1970s onwards, these works have been confined to books and articles without realizing practical application in real life except some Islamic finance models like Zekât and Evkaf applications. Essential shortcomings of the Islamic economy, such as very diverse approaches between scholars and economists, lack of real life analysis, lack of a general equilibrium model for macroeconomics, uncertainty of the role of Shariah, and Islamic financing practices of central banks, have to be filled by scientists and practitioners (Al-Jarhi, 2013).

The reason for the failure of Islamic economics work is that it cannot transform them into the epistemological and sociological and historical foundations of the modern economy, that is, they cannot transform them according to the normative position of Islam without successfully closing the meta-principles at the root (Jha, 2013, p. 171). Some researchers have found that the problem is the lack of a strategic vision in studies related to Islamic economics.

Some critics of the subject have gone too far. Sohrab Behdad, for example, stated that "*the Islamic economy is devoid of the ability to create a viable social alternative*" when referring to the Islamic economy's implementation attempts in Iran, and Timur. (Zaman, 2012, p. 145).

Much more analysis has been done on the reasons behind the backwardness of Muslim societies. However, it is a problem to overlook the intrinsic capability of the Islamic economics to solve the problems while focusing on various policy packages and institutional structures in. For this reason, it is thought that this research that we made on the discipline of Islamic economics should contribute to the literature with its sociological dimension and it should be determined whether Risale-i Nur contributes to the issue as a religious work in Turkey.

Many studies under the name of Islamic sociology have tried to create a discipline in this area, but since they are on the traces of positivist sociology with their basis on Islamic approach, they are trying to put Islamic labels on only some concepts existing in positivist sociology without doing sociology, and a serious problem arises due to the influence and self-awareness that was pointed out in academic studies (Keskin, 2012). In addition, it has been determined in various researches that Islamic sociology has a serious methodological problem in any case (Canatan, 2012).

It is understood that both the Islamic economy and Islamic sociology still continue to mature as potential scientific disciplines while some problems persist in this process. However, analyzing through the literature at the intersection of both disciplines that help one another and benefit each other will contribute to solving the problem of making evaluations in light of contemporary Koranic commentaries.

Sociological Foundations of Modern Economy

According to Marx, when “economic structure of society” is determined by the relations of production, these relations are inherently social in their nature. The production relations in a society are constant and structured according to legally defined power relations. The capitalist market structure is also made up of these social relations (Cahill & Paton, 2011, p. 14). The social character of the markets is also a central problem of economic sociology (Cahill & Paton, 2011, p.18)

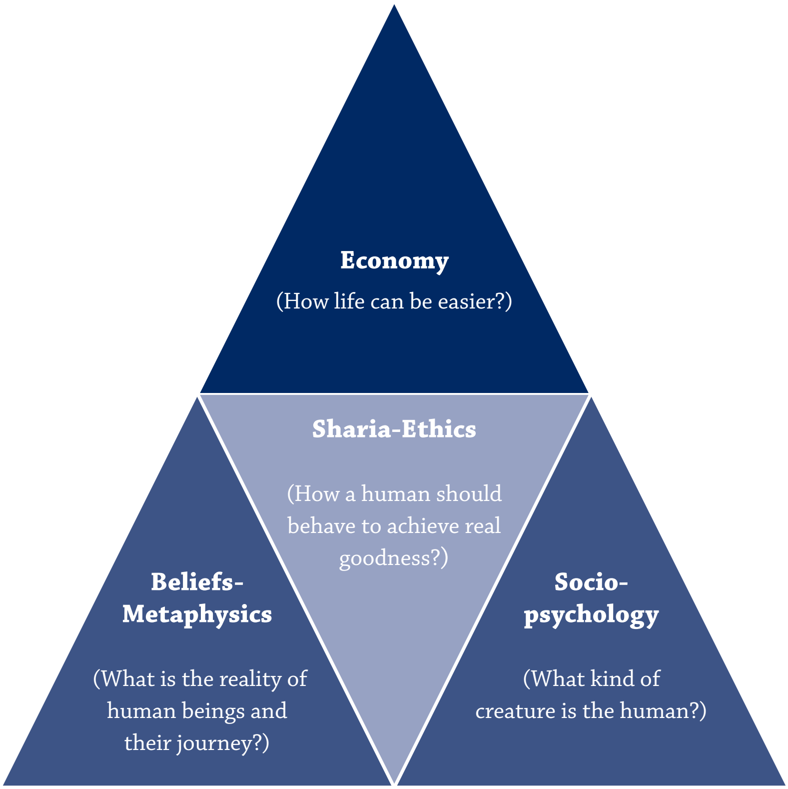

Figure 1. Relations / hierarchy of intellectual disciplines

Max Weber is the founder of economic sociology (Sunar, 2012, p. 37). Economic sociology can be considered as a part of general sociology, not as a technique that can be evaluated within the scope of economics (Kurtakko, 2014, p. 32) Smelser and

Swedberg in their book called "*Handbook of Economic Sociolgy*", defined sociology of economics as "*The application of sociology's reference, variables and explanatory models to the complex production, distribution, exchange and consumption activities of scarce goods and services*" (Hayes, 2012, p. 54)

Positive economy uses a behavioral model based on maximizing utility of producers and consumers. But this approach fails at the point of lack of loyalty, dutifulness and virtuous behavior. It is important to examine human relationships and the driving forces behind it because the behavior of individuals in society affects the society as a whole and constitutes the sociological structure of society.

As can be understood from Figure 1, firstly it is necessary to define the nature and reality of existence. This can be understood by scientific research conducted on revelation, inspiration, religious values, understandings and acceptances, called the metaphysics. Only positive sciences such as biology, chemistry and physics can describe the formation and material nature of material reality. However, the fact that the substance, the cause of formation, and the atomic structure are the same everywhere, but it is moving and interacting in a state of having unlimited knowledge, power and wisdom that can not be explained with bare material laws. Wisdom is not present in positive sciences which do not try to find an answer for "why" rather than mere "how". This can be answered by sociology or anthropology as well as by religious values and assumptions that lean on revelation of the unseen. Ethical values, sharia, legal requirements and moral systems respond to the question of "*how can we achieve common good by exploiting wealth for human beings and effectively using limited resources for unlimited needs?*". At the top of these, the question of how human life can be facilitated, as expressed by Wishloff (2009), is answered by the economists. Policy packages as well as institutional structures, are strirring and effecting the social conditions and sociological relationships that determine the behavior and preferences of all actors in facilitating human life due to the fact that human is a social creature of God.

Religious culture, sociology and economic relations

Economists such as Max Weber and Robert Barro, who are as diverse as Karl Marx, point out that there is a relationship between economic organization and religion. Weber was primarily concerned with Christianity, while Barro expanded his perspective to include Islam. According to Koehler, who claimed the Prophet Muhammad was the first economist that made his religious call after 20-30 years of his commercial entrepreneurship. His personal nature and work in the business world affected his approach to business and politics, and this has gradually turned into an Islamic economy. Islamic trade categorically linked to China, India, Africa and Europe draws less attention than military and political issues. However, the transition from the antiquity of the Mediterranean to the first real world global trade system was actually the product of Islamic relations. Therefore it is claimed that the Prophet Muhammad came from an economic understanding (Koehler, 2011).

In his book entitled "*The Protestant Ethics and the Spirit of Capitalism*" of the sociologist Max Weber, which deals withaddresses the relationship between capitalism and bureaucracy in a religious perspective. It is emphasized that the religious relations and the process of capitalistization in the societies are determined according to their religions orientations which are different in societies in their historical development (Gundolf & Filser, 2013, p. 177). As well as how they affect social and managerial realities and the effects of religion on the process of capitalist development is also studied by Weber who had argued that the religion is seen in the roots of capitalism. It is seen there that puritan is evaluated not in terms of ethical religious affirmation but in terms of the effects of religion on property and process of capital accumulation. Thus, in his analysis related to capitalism's developmental process, it may be incomplete to ignore religion and religious lifestyle, which reflects its partially reflective social philosophy. In fact, it is a well-known fact that religious approaches constitute the source of the economic life and, consequently, the rise of capitalism. However, it can be argued that while the rise of capitalism is the great contribution of religious transformations of the 16th century, it is said that religious values are dramatically regressing in the ascension of capitalism (Wilber, 1974, p. 257).

Minkenberg (2007) examines the influence of Islam and Christianity on modern state and democratization comparatively, claiming that the roots of modern democracy are based on Christianity. A researcher examining the views of Protestant theologians argues that while modern Protestant theologians criticize libertarians on one side and non-human and spiritless materialism on the other. It is argued that these dual criticisms reveal that the powers of social institutions must be balanced by individual freedoms, which is the essence of modern religion (Riis, 1989).

Bediuzzaman also corroborates the fact that the European civilization is not a state of art of irreligious philosopy and materialism but rather it stems from remnants of celestial cristianity.

> *"It should not be misunderstood; Europe is two. One follows the sciences which serve justice and right and the industries beneficial for the life of society through the inspiration it has received from true Christianity; this first Europe I am not challenging. I am rather addressing the second corrupt Europe which, through the darkness of the philosophy of Naturalism, supposing the evils of civilization to be its virtues, has driven mankind to vice and misguidance".* (Nursi, 1970, p. 160)

Religion, which can be regarded as a phenomenon that has also sociological effects, may be used to analyze the development process of capitalism, and it may show the lack of research to ignore the religious culture that effects the sociology. However, Weber's analysis of economics and sociology revealed that he had misinterpreted Islam as "*a religion of Bedouin Muslims composed of disciplined warriors motivated by the expectation of booty, conquest, and sexual desires, not of urban intellectuals"*. Researchers have also argued that they have not found the correctness in his evaluations. Some researchers, such as Rodinson, have suggested that Islam is more a supporter of commercial activity than Weber's critique, and that the contemporary backwardness of Islamic societies is not their religion but a political factor stemming from western imperialism that has been exploiting them (Kurt, 2010, p.21) For this reason, it can be said that in the evaluations made on the concept of religion, the subjectivity and abstraction must be evaluated separately for each religion and society. However to clear the misperception regarding İslam and its eligility for material development and civilization, we refer to Bediuzzaman who refutes those kinds of arguments by bringing sociological, historical and economic reasoning.

> *"Do you suppose this nation's poverty is the result of a sort of religious asceticism or of laziness arising from abandoning the world? You are wrong to suppose that. Do you not see that the nations dominated by Europe like China, and the Brahmins and Zoroastrians of India, and the blacks of Africa are poorer than we are? And do you not see that nothing apart from the most basic subsistence is left in the hands of Muslims? The rest is either stolen or seized by the European infidel tyrants or the dissemblers of Asia."* (Nursi, 1970, p. 169)

According to Marsuki (2009), who has explored the relationship between sustainable economic development and Islam, religion is one of the most ethical systems of government in many societies around the world. According to contemporary Muslim scholars, Islam has its own approach to sustainable economic development (Marsuki, 2009, p.22) Therefore, religion, culture, beliefs and tendencies can be considered as the most important parameters affecting economic relations on the basis of social and managerial orders. It is necessary to analyze how these parameters affect human behavior in the sociological dimension and especially the effects of Islamic fundamental values in Turkish Muslim society in particular. The effect of religion can be realized with true faith. Faith cannot reveal its reality unless it turns into socio-economic actions.

Then one can ask that can the economy be enriched by religion or religion-like concepts, approaches, thoughts and paradigms, in spite of the fact that it is mostly based on sociology? In fact, it can be contributed to the rise of the economy, which can also be regarded as a moral science. Much must be done to enable the entry into the economy based on ideas shared by all religions regarding critical concepts given by the creator such as mankind's unity, honor of personality, personality rights, freedom and individual preference and respect (Mirakhor, 2014).

It is a necessity to study their sociological bases, as the principles that religion puts forth include the sacrifice of man's own possessions, working for the benefit of others, refraining from both self praise and satisfying own egos. Sociological factors such as group psychology, social consciousness and neighborhood pressure undoubtedly also affect religious life and its effects on economic relations. Therefore, what shariah brings for social life of Muslims and how Islamic economy includes sociological structures needs to be delved.

Shariah, social life and Islamic economy

Undoubtedly, Islam examines life from a neutral point of view that appreciates the constructive elements of this life by seeing that they complement and support each other. All of the elements are given relative importance in solidarity and harmony according their reality. Anyway, the material direction takes its support from the spiritual direction as the life leans on the soul.

At the same time Islamic economic principles that can be classified into macro and micro areas are intertwined with other moral, sociological, philosophical and pedagogical principles. Hence, it is not a utopian theory that Islam can be applied in real life without the pressure of a secular or dictatorial government that has not realized the true value of human existence, but the successful examples of Islamic history in which it was implemented entirely to practice, to life, to fruity and to positive results. The so called"*Asr-ı saadet*" and afterwards were an experienced and verified specimen of all the fine works that left everywhere with the approach of forming Islamic states that were spreading peace and prosperity to humanity all over the continents and were being considered as the super powers in their times, building civilizations of serving humanity instead of a colonial understanding of different kind of exploitations.

It is stated that the most famous work on Islamic sociology is written by Ali Shariati but it can be expressed as sociology in the classical meaning and its work can be expressed as "*an effort to find a middle way*". Ali Shariati argued that the transformation of the mindset required for the transformation of societies into "*the struggle of right and western, monotheistic with tawhid*, requires a unity-based philosophy of history and sociology (Keskin, 2012, p.21)

Sayyid Hussein Nasr, who made sociological assessments in his book "*Traditional Islam in the Modern World*", has argues that western colonialism is based and has achieved legitimacy on the basis of its formation of reductionism, secularism, mechanics, and pragmatism. On the other hand, in the Islamic perspective he argues that the sacred text, which explains the relations of all existence (nature, human being, universe) as a creation, represents a scientific approach which explains the book of the universe (Keskin, 2012, p. 21)

Every state that is a '*welfare state*' has the ideal of protecting the needy citizens who are not self-sufficient, even if there are some troubles in realizing it. Today, governments are struggling to provide a standard of living for the poor citizens of society with the social security systems, the most important means of social policy. This approach is one of the most important steps in the modern state's understanding of the state. However, it is a fact that Islam has revealed this stage that the modern world has reached recently fourteen hundreds years ago, by mentioning the spending areas of zakat, which is a fixed and specific income, without leaving the needy citizens to the mercy of the individuals (Dumlu, 2011, p. 221).

In fact, the foundation of social welfare depends on the provision of a fair distribution of income. Because, in order to be able to talk about social welfare, it is necessary for the society as a whole to overcome the problems of middle class and the poor people rather than the rich only, as well as the problems of unemployment, poverty and hunger. In other words, social welfare cannot be realized only by a high economic level of particular elite in a society (Çayıroğlu, 2014, p.172).

The Prophet Mohammed said that the state must fulfill all the needs of all people. The state is responsible for the welfare of the people. "*A president, who is obliged to the work of the believer but does not work with sincerity for their welfare, can never enter the paradise with them*" (Tirmizi; Muslim). In the light of these hadiths, the public administration is obliged to ensure the safety of life and property of people and to set standards for their normal living conditions. The main objective of the social policy to which the state belongs is to bring peace, justice, prosperity and security to all segments of society. According to the co-operation principles, the social unions to be established by those who work in industry and agriculture and those who are self-employed are one of the guarantees of the social security for the whole people as well as a means for the state to keep these people under the supervision of other people (Tabakoğlu, 1988, p.128)

According to Talegani, who works in economic and social fields, social assistance and cooperation are exceeded in a society where there is true Islamic education and where true belief and obedience (avoiding sin) dominates because a society that shares goods and means of livelihood is like a family. In the first years of Islam this ideal was fulfilled. The Prophet made a fellowship agreement between the Meccan people who emigrated to Medina for help. They shared all their economic possessions although they were not rich (Talegani, 1989, p. 169). In Islamic law, the relatives were given legal obligations for nutrition, dressing, accommodation and treatment. Husband, wife, and any person is obliged to meet such needs of relatives in some circumstances. The obligation among relatives is virtually absent in contemporary legal systems. According to Tabakoğlu, this situation is unique only to Islamic Law. According to this, children, grandchildren, mother, father, grandmother, grandfather next to uncle, sister, sister child, aunt, uncle blood relatives are also mutually alike. Such an obligation can be established among all the people who may be extended to each other by enlarging this circle (Tabakoğlu, 1988, p.52) As a matter of fact, this framework was kept wider in the Hanbali sect. Procedures, remuneration and spousal rights of wife do not automatically depend on any provision, but this right of other relatives arises by consent or court decision. In order to be eligible for "*nafaqa*" the compulsory financial contribution is required in a situation where the woman is poor and the male is both poor and unable to work. In addition, the person who will give the nafaqa should not be in need of anyone else.

The Islamic economy is in essence the rules and institutions that are included in the Shari'a's "*Muamelat*" group. In other words, the Islamic Economy is regarded by some scholars as a subdivision of the science of economics which is engaged in the economic side of the Islamic law, which is a social science based on essentially normative but positive basis. Accordingly, the regulations of Islam in the field of economy constitute the "Islamic Economy". Islamic law is sometimes referred to as "*al-fiqh-ul-iktisat*" because it is seen as a sub-branch.

However as an independent discipline, the Islamic economy is inevitably tied to Islamic theology and law as it needs a systematic resource and support. Somehow there are deficiencies in the intellectual interaction between Islamic economists and scholars of jurisprudence. Islamic economists come with models of participatory financial systems based on financing and large-scale risk sharing. Islamic jurisprudence deals mainly with the use of traditional tools or derivatives that are appropriate to Sharia. These efforts have also led to Islamic financing becoming closer to the traditional status quo and away from alternative forms of financial intermediation. Although this does not contribute to the development of Islamic economics as a new paradigm, the process can be reversed (Nienhaus, 2013, p.169).

The Islamic economy, as distinct from other economic systems and theories, has its own unique characteristics with its religious values, so its principles and institutions are closely related to the philosophical, psychological and sociological structures. Islam does not suggest a model of artificial and assumptive human portraits i.e. the "*homo economicus*" for economic development and prosperity, but merely sets principles that will yield the most appropriate human model for eternity. (Ansari, 1994, p.398) What is meant by the religion as a means of solution is pure, unshakable monotheism, which can provide a harmony between religion, personal instincts, individual needs, general social interests and practical outcomes, and gives the keys to man to live in peace while striving for eternity. The Islamic Economy also emerges as the general framework and reflection of this order as it is shaped by the philosophical, psychological and sociological considerations of man and is part of the whole social order of life.

The Sociological Basis of the Economy in Qur'an and Hadith

It is inevitable that the economics is related to social issues because of the necessity of the mutual relations of people, such as the sociology of life, the mood-reflecting behavior and interaction of people. When we look at the economic principles of Islam, it is seen that most of the rules and institutions are still social. They are aimed to protect the social unity and to prevent the irregularities i.e. *zakat*, unrequited alms and *karz-ı hasen* are related to the social relations of the society as well as to the removal of the interest. So, as will be seen below, it can be said that almost all of the Islamic economic principles are aimed at strengthening social solidarity and eoconomic resillience.

The social dimension of this subject is very obvious from the orders and prohibitions of Islam's main sources. For example, according to the Qur'an, infak (unrequited aid) is considered as one of the special qualities of the person who owns*takva*. There are many verses in the Qur'an which are related to the field of sociology as well as economics. From these verses, it becomes clear that the value of gratuitousness from the point of social unity and solidarity and mutual trust, is eppreciated in Islam. The goods or money that is incurred (spent) constitute the income of someone else. Again, it is clearly in the verses that the property of the weakest is not harmed, but that it is reproduced with the mercy and consent of Allah. This means that economic development can also be achieved as a result of acting in accordance with God's will. Below are examples from the Qur'an that may be related to sociology in this sense:

"... They give forth from the blessings that we have given them" (Bakara 2/3).

As it is understood from the verse, it is encouraged to cooperate to strengthen social ties.

"*Allah does not want difficulty for you, but for convenience*." (Bakara 2/185)

As it is understood from the verse that all sociological or economical problems must have a solution and ways which are easy to adopt should be preferred.

"If you do not join the jihad[1] *collectively, He will make you a painful doom and bring another people to your place, and you will not hurt him. Allah has power over all things.* " (Tevbe 9/39).

As understood from the verse, in some cases it is necessary to act in the sense of social responsibility. A collective harm is a harm done even if just to one individual. Societal peace can not be maintained in a sustainable way without taking measures at the social level and paying its social price.

"*So why were there not among the generations before you those of enduring discrimination forbidding corruption on earth - except a few of those We saved from among them? But those who wronged pursued what luxury they were given therein, and they were criminals*""(Hud 11/116).

As it is understood from the verse, it is described as a crime to be deceived by wealth and worldly favors, to pursue the self, to not think about others and to commit bad deeds for carnal pleasure. Here, too, the issues that are entering the sphere of economy and sociology are seen.

"Say, Indeed, my Lord extends provision for whom He wills of His servants and restricts [it] for him. But whatever thing you spend [in His cause] - He will compensate it; and He is the best of providers." (Sebe 34/39).

1 Jihad means to strive for the Word of God and real goodness of people.

Solutions of sociological and economic problems regarding the fulfillment of social responsibilities and the utmost efforts are achieved with the expression of "*yurbis-sadakat*".

"Here you are - those invited to spend in the cause of Allah - but among you are those who withhold [out of greed]. And whoever withholds only withholds [benefit] from himself; and Allah is the Free of need, while you are the needy. And if you turn away, He will replace you with another people; then they will not be the likes of you."(Muhammad 47/38).

This is a sign that Islamic provisions must be taken into account not only at individual but also at societal level.

"*O mankind, indeed We have created you from male and female and made you peoples and tribes that you may know one another. Indeed, the most noble of you in the sight of Allah is the most righteous of you. Indeed, Allah is Knowing and Acquainted.*"(Hucurat 49/13).

As it is understood from the verse, it is necessary to treat people with different tribes or nations without hostility in this sense and not to exclude them because of being from a different race. This requires the development of a social consciousness and social cohesion.

"*In the goods of theirs are the right of needy and the poor*" (Zariyat 51/19).

As it is understood that in the social environment, one should not assumed to be grateful for being helped and should not be left in a psychologically bad situation. For in the property of the rich to be expressed as the right of the poor means not to rennify a person with the emotion of granting the right of the poor, whom Allah gives to them as trusting, not something belonging to them when giving the rich.

Some examples of related hadiths are given below:

"*Do not underestimate any good if your religion consists solely of a gentle face*" (Muslim, 1:144)

If people who are not economically able to provide financial aid to other people are unable to make a contribution, at least smiling at them and saluting are supported by sincere feelings of strengthening social ties and solidarity which is described as charity according to a hadith.

"*On the Day of Resurrection, there is nothing heavier than good moral in the belie-*

ver's scales. Allah Teala hates anyone who makes ugly deeds and says ugly words "(Tirmizi, 1:61)

The importance laid upon good moral values reflects the importance given to the protection of relationships among people. It is implied that even though they can be good pious servants of God in a pure sense, but if they hurt others or act selflessly without social responsibility for the sake of self-interest, they are in a great loss.

"*Goodness is good morality. Sin is what you do not want people to know if you keep scratching your heart*. "(Muslim, 1:14,15; Tirmizi, Zuhd:2)

"It is not from us, who do not understand the glory of our elders" (Abu Dawud, Edeb: 58; Tirmizi, 1:15)

The last two hadiths were was originally intended to show social aspect of sins and to give respect to elderly people in a society. Everyone in their community has their own elders and youngsters. It is preached a Muslim should not be ruthless to the minor ones, i.e. the weak ones, and furthermore should not be disrespectful towards his elders.

Two opposing concepts such as competition and solidarity in social life are two important aspects of life that exist in the realm of living things. The fact that solidarity is accepted as a basis at the beginning of the work largely prevents the emergence of factors that cause undesirable things as monopoly Social solidarity and co-operation also fall within the framework of legitimate activities: "*Help on goodness and supplication, do not help on sin and oppression*" (Maide 5/2) clearly demonstrates this. "*(Muslims) prefer them to their own souls, even if they themselves are in poverty and need*" (Hasr 59/9). This situation, which is seen in this verse and shows its final application to the lives of the virtious in the sense of preferring the souls of others to themselves, has a separate prescription from the point of strengthening social ties as well as is a result of sincerity and true belief.

Islam normally discourages any intervention in properly functioning mechanisms. However, in cases where there is a disruption, intervention is recommended to eliminate the factors for deregulation. If market disruptions leads to erosion in workers' wages or if the market balance occurs at a very low point then the state may intervene at the point where the widespread accepted rates for similar jobs are applied by others. In some sectors, such as farming, construction, weaving and other public services, it is difficult to reach a balance with market dynamics when individual enterprises do not invest. If there are entrepreneurial deficiencies in sectors like these in the community, investing in these sectors becomes a religious obligation. If no one invests in these sectors, or if there is a lack of workers in some areas, then public initiative and some people may have to work or invest in these areas. In these cases, the state must provide a minimum wage for this person or provide the payment (Ahmad, 2011, p. 595).

Qur'an refers to Prophet Moses' work as a wage for eight years (Kasas 28: 27). Elsewhere, it is mentioned that people will be paid for a wallcovering (Kehf. 18:94). However, it is stated that he rejects those proposals and gives them an idea that they can construct such a wall by organizing their own labor. At the same time, the Qur'an also includes the use of wage earners to collect and distribute intelligence (Nur, 9:60). Throughout the life of the Prophet, there was a group of companions called "*Suffa*" people who lived in the mosque, who also emerged as the first public officers dedicated to him (Ahmad, 2011, p.597)

Risale-i Nur Approach to Sociology of Economics

The Risale-i Nur Collection, written by Bediuzzaman Said Nursi (1876-1960), consisting of a total of 130 pieces of books, was compiled during the Ottoman period until 1950. It is a "tafsir", Quranic commentary in the sense that it contains the answers from the Qur'an to the objections made by western philosphers over the faith and Islamic principles. It gives powers of the intelligent proofs to the sincere blieves which are brought to the attention of people with the intensification of materialism and devotion to worldy life. It has been determined that in the Risale-i Nur Collection, the word "sociology" has never been mentioned. However, 193 times the word of "economics" was found.

It has been proved by academic studies that Islamic philosophers are generally influenced by the ancient Greek philosophy. (Sidani & Ariss, 2015, p. 850) In the Risale-i Nur, the well-known scholars of Islamic sociology are also influenced by scholastic European philosophers, who are known as the "*Felasifiyyun*" and try to explain them with logical assertions and representations by supporting them from the Qur'an and the hadiths that the way that the Qur'an shows is very easy and accessible to all.

In many analyses on verses and hadiths, sociological and economical references or remizations are made indirectly. When we look at the fact that the hadiths point out that "the world is for the afterlife", it can be said that there is an aspect to the Hereafter for every individual who cares about worldly life. Almost every divine judgment is examined in detail, subject to the analysis of the personal and social dimensions of the part of life related to the Hereafter.

Worship in Islam is not limited to prayer and fasting, but it can be regarded as a worship to conform to economic principles too. In other words, the application of Islamic economic provisions is a form of worship since the rules about economic life are based on verses and hadiths. In accordance with these provisions, in the case of having a religious perspective, human is able to live as if he has spent his life in prayer by acquiring a constant peace with the awareness that he is at His disposal at any moment.

Accessing wealth economically, accumulating capital, or becoming famous in social status are not the values favored in Islamic economics. *"The beauty of perfection is religion. Religion is light of welfare, the feeling of happiness and the salvation of conscience* (Nursi, 1993, p.54). Islam shows how human beings have enjoyed their deepest feelings. The fact that Caliph Imam Ali was in the court judged with an ordinary Jew, Salahaddin-i Ayyubi was in court judged with miserable Christian, and Sultan Fatih was punished by couth for a Greek Cypriot are recorded in Islamic life as a few examples of how to embrace and correct the whole justice, solidarity and virtue in social life of a society in İslamic histoy.

The one-sided view of materialism, which is also referred to as materialism that affects Muslim societies today, has led to the imbalances in the economic and social structure of the societies. As Bediuzzaman puts it, "*the wisdom of the conscience is the religious sciences, and the light of reason is the positive science of civilization (humanities). Truth is manifested from the infusion of the two. Otherwise, the first one produces bias, and the second one is cheating and doubtfulness*". In other words, if the humanities and modern and religious education are not integrated together, the society will not be able to get rid of ignorance and misunderstandings.

Muslims can not feed their stomach relaxed while their neighbors are hungry. The Kur'an uses a very hard expression for those who keep the money out of circulation by not spending it in good deeds. "*Give glad tidings of punishment to those who accumulate gold and silver and do not spend in the cause of Allah*" (Tevbe 9/34). Again, the Qur`an asks people not to be stingy or wasteful in spending: "*Wasted, extravagant, ungrateful to Allah*" (Isra 17/16). Here too, the social and economic aspects of prohibition of wastefullnes are explained, which lead to the destitution of the societies by destroying the resources.

> *"Irreligious philosophy accepts 'force and power' as its point of support in the life of society. It considers its aim to be 'benefits'. The principle of its life it recognizes to be 'conflict'. It holds the bond between communities to be 'racialism and negative nationalism'. Its fruits are 'gratifying the appetites of the soul and increasing human needs'. However, the mark of force is*

'aggression'. The mark of benefit —since they are insufficient for every desire— is 'jostling and tussling'. While the mark of conflict is 'strife'. And the mark of racialism — since it is nourished by devouring others— is 'aggression'. It is for these reasons that it has negated the happiness of mankind." (Nursi, 1960c, p. 122).

It is known that non-Islamic philosophy leads to serious sociological destructions. The social disasters brought about by the first and second world wars are the greatest evidences. Because of the material, political and economic supremacy of the strong and powerful ones, social traumas come to the force in the face of all kinds of conflicts,the oppression of the weak and the power of domination according to irreligious philosopy is what holds societies together under nationalism and racism. This has produced sociological separation and hate and hostility that are difficult to overcome, because it is trying to swallow and assimilate others. As a result, what human civilization puts forth is to make people desperately needy by trying to satisfy the desire, pleasure and social needs.

"As for the Qur'anic wisdom, its point of support is 'truth' instead of force. It takes 'virtue and God's pleasure' as its aims in place of benefits. It takes the principle of 'mutual assistance' as the principle of life in place of the principle of conflict. And it takes 'the ties of religion, class, and country' to be the ties bonding communities. Their aims is to form a barrier against the lusts of the soul, urge the spirit to sublime matters, satisfy the high emotions and urges man to the human perfections, and makes him a true human being. And the mark of 'the truth' is accord. The mark of virtue is 'solidarity'. The mark of mutual assistance is 'hastening to assist one another'. The mark of religion is 'brotherhood' and 'attraction'. And the mark of reining in and tethering the soul and leaving the spirit free and urging it towards perfections is 'happiness in this world and the next'."(Nursi, 1960c)

On the path of Islam, it is essential to be justified instead of using force. Power, reputation, fame, authority, position and money can not justify the unjust. A little bit of innocence is reserved and paid in a way by İslam. For this reason, the rightious becomes the victor and it is not invincible. Instead of conflict, assimilation and struggle as a social basis, and help and goodness are essential. Relations between civil society are not based on race and nationality, but on religion, class and social relations.

Bediuzzaman argues that Islam can not be compared to other religions because Islam has regulated both the economic and administrative and sociological spheres, and consequent changes in other religions or transformations in the historical sense can not be applied compared to Islam. In fact, since the sociological and economic provisions of Islam are regarded as the basis of religion, it also means that changing them means changing the religion's core at the same time:

> *"in the religion of Jesus, only the fundamentals of religion were taken from Jesus (Upon whom be peace). Most of the injunctions concerning social life and the secondary matters of the Law were formulated by the disciples and other spiritual leaders. The greater part was taken from former Holy Scriptures. Since Jesus (Upon whom be peace) was not a worldly ruler and sovereign, and since he was not the source of general social laws, the fundamentals of his religion were as though clothed with the garment of common laws and civil rules taken from outside, having been given a different form and called the Christian law. If this form is changed and the garment transformed, the fundamental religion of Jesus (Upon whom be peace) may persist. It does not infer denying or giving the lie to Jesus (Upon whom be peace). However, the Glory of the World (Upon whom be blessings and peace), who was the owner of the religion and Shari'a of Islam, was the sovereign of the two worlds, and the East and West and Andalusia and India were his seat of rule, he himself therefore both demonstrated the fundamentals of the religion of Islam, and brought the secondary matters and other injunctions of the religion, including even the most minor matters of conduct; he himself taught them; he commanded them. That is to say, the secondary matters of Islam are not like a garment capable of change, so that if they were changed, the essential religion would persist. They are rather a body to the fundamentals of religion, or at least a skin. They have blended and combined with it, so that they cannot be separated. To change them infers direct denial and contradiction of the owner of the Shari'a"* (Nursi, 1960a, p. 435).

The amendment of religious provisions should not be confused with case law. The case-law is based on the interpretation of the provisions according to the requirements of time, taking into account the comparisons made to scholars in the past concerning the application of the Qur'an and the Hadiths in such a way as not to contradict the clear provisions called basic nas. Bediuzzaman writes the basic principles of the Islamic economy in his book entitled "İktisat *Risalesi*".

In its essence, it gives the basic messages about how the world's life should be used for the eternal life that is instrumental, not central. The following basic principles can be drawnfrom Risale-I Nur Collection:

1. The wasting of resources to obtain fantasies of traditions or miserable civilization leads to overpayment, inefficiency and dissatisfaction resulting sociological problems.
2. The legitimate flavor and benefits can be followed on the condition that it does not cause begging and downgrading.
3. Tasteful things, comfortable environment and personel pleasure may be sought, provided that the heart and mind rules over emotions and tendencies.
4. In the case of special circumstances that prevent human life from continuing, it is possible to resort to exeptions to use it for the purpose of facilitating the life of the world.

5. Reasonable fruguality is the outlook and generosity. Stinginess and insecurity are the inside of the apparent roller features of the scavengers and scatterers. While fruguals do not suffer from the point of livelihood, those who waste resources, waste their lives to become dependent on others and lose their independence because they will continue to spend and borrow, even if their income increases.
6. Negotiating is necessary in the economy to protect confidence and integrity. Bargaining provides the exchange of information and interaction among people as a social relationship, as well as sets market prices.
7. There is no charity in waste, as there is no waste in charity. The constant rush to charity leads to an increase in tax revenues as well as production and employment rates and demand in the market because charities are activities that strengthen social solidarity and unity for the benefit of society.

Conclusion

Economy is shaped by human preferences. Macro and microeconomic changes are influenced by households as producers, employers, and taxpayers, depending on the preferences of the investors regarding their expenditure areas and quantities and the behavior that determines the solutions to the economic problems. As a result of our analysis, our research questions could be answered as follows:

- *Can economic principles of Islamic religion be analyzed in terms of sociology?*

Islam has an approach centered on religion, people and sociological relationships. Nearly all of the Koran, the addresses of Allah like "o you people", "o you blievers" atc, are always towards society not to individuals with some exeptional cases of addressing directly to the Prophed Himself. Therefore, in general, the verses in the Qur'an address not only individuals, but also always consider the community and show society in a way beyond the sum of individuals on public law. All religious orders and provisions can actually produce a sort of sociological outcome. Social culture and community life are very important issues in Islam. It is aimed to strengthen sociological relations and protect the unity of Muslims with basic principles such as giving importance to making worship together rather than individually, giving more importance to festivals, cooperation, neighboring relations and working for the benefit of mankind.

It is aimed at eliminating all the factors that may cause the dissolution of sociological ties. Again, it can be said that in the society, conflicts and misfortunes are described as the corruptive sins as much as killing humanity. It can be said that Islam is aiming to remove all the factors that could harm the consciousness of a society. There are many Verses and Hadiths that directly address the strengthening of social fabric and social relationships, such as the deceivers are not from us, that the believers must feel the pain of the believer as they are like flesh and nails, the constructive effect of the interlocking stones that make up the buildings.

- *Is Risale-i Nur contributing to the sociological bases of Islamic economics in terms of being a contemporary work in Turkey?*

There are few provisions about social life in every direction, which regulate the relationship with other people and nature. In this sense, preferences regarding production, consumption and investment may change according to religious values, as the behavior of religious people in life can change. For example, orders such as avoiding interest and giving zakat are as serious as economic and sociological deeds. For this reason, it is not possible to change them.

In the Risale-i nur approach, it can be said that it is a methodology to explain the wisdom of religious principles, to reveal its logical foundations and to prove that it has beneficial results for humanity. The main reason for this approach is that the necessity of appealing to reason is the advancement in science and philosophy, and that it has to be explained from the point of view of the evidence to reveal desired direction. *"... the true pleasures and the unqualified taste and the joy of happiness and the happiness in life are in the circle of the faith,* or there is a worldly flavor that has many things, such as eating "a grape, being slapped ten times" Therefore, sociological analyzes of the chamber of faith are also being conducted.

One thing that is closely related to sociology of economics in Islam is that the interest is made forbidden and zakat has been prescribed. One thing to note here is that social peace and social solidarity within the scope of economic sociology are fundamental issues. Risale-i Nur emphasizes that the balance between the social classes can only be preserved by measures of the Qur'an. It is only in this way that the Qur'an's most basic principle for man is to "live in obedience"; On the other hand, this balance can be maintained as long as we live in the state of being without interfering with the duty of Allah at the point of giving provision by doing our own duties that is the taqwa and the good deeds. According to Said Nursi the author of the Risale-I Nur Collection, the two most important factors that disturb the social equilibrium are the dominance of interest and the absence of zakat. These two elements are expressed in the reflection of the interest on the basis of social life that "I am working, I am eating", and the basis of not complying with the zakat commandment is the expression of "*what is it to me if someone else is dying of hunger when I am full*"?

The Qur'an aims at solving not only an order of happiness, but also the economic and sociological problems that are settled within the society at the same time. Because the traders, craftsmen, investors or consumers who own the loans given by the depositor's owner, feed their depositors with their own works by giving interest. Deposit holders have no risks, and even if borrowers are bankrupt, interest receivables are collected in a guaranteed manner, even if their assets are liquidated and enforced. This leads to the enrichment and compassion of deposit owners. The lack of zakat is also leading to an increase in crime rates and an increase in corruption among the classes because they are not concerned about the hunger of others and therefore do not respect the poor. It is argued that these two concepts lay at the basis of the turmoil in the history of mankind, "the fesad", the revolutions and the moral disturbances. This means that sociological problems are a hunch as a serious burden on public finance and that public order and social unrest can not be prevented. There is no doubt that if the practices to be performed in the light of the Qur'an and Hadith are supported by faith and true judgment, Risale-i Nur is also defending it.

Therefore, it can be said that it puts forward the principles of sociological basis of economic life. As mentioned above, especially when the wisdom of the removal of the interest and the order of the zakat is explained, it is taken up in a completely sociological perspective. It draws attention to the importance of basic wisdom in the demolition of interest and the ordering of zakat. It can be said that in the prohibition of interest there is functionality that solves conflict between the labor and the capital, which prevents the sociological problems that has threatened humanity for centuries. Also in the order of the zekât, the fights between the upper and lower classes are being resolved by setting a bridge filling sociological gaps. In other words, it is aimed to establish social ties by bringing communication, and interaction between classes with respect and courtesy.

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Interest Rate Risk in Interest-free Banks:

An Empirical Research on Turkish Participation Banks

İlker Koç

Abstract: Participation banks, which are globally called Islamic Banks or interest-free banks, basically receive funds based on profit-loss sharing principle and make loans via purchasing a commodity or a service and selling it to customers for a higher price (murabaha method) or profit-loss sharing investment contracts (mudarabah or musharakah method). In literature, most of theoretical studies suggest that interest-free banks' business model is based on profit-lost sharing principles and therefore unlike conventional banks these institutions are not exposed to interest rate risk. Conversely some empirical studies suggest that Islamic banks' profitability is affected by market interest rates and these institutions are exposed to interest rate risk. In this study, with reference to Basel Committee's definition of interest rate risk, effects of market interest rate fluctuation on the profitability of Turkish Participation Banks has been analyzed with Seemingly Unrelated Regression method for the period between June 2005 and June 2016. It is found that there is a significant relationship between the profitability of the participation banks and interest rate changes and therefore each institution is exposed to the interest rate risk at different levels.
Keywords: Islamic Banking, Interest-Free Finance, Interest Rate Risk, Seemingly Unrelated Regression.
JEL Codes: G21, G32, C58, Z12

Introduction

Islamic banking or interest-free banking or participation banking, as called in Turkey, is defined as a type of financial activity that allows the transfer of funds obtained from parties with excess saving to saving deficit parties without violating Islamic religious rules (Obaidullah, 2005). In Turkey and many other countries, interest-free financing practices are increasingly on the agenda of academia and policy makers. Main factors contributing to the rapid development of interest-free finance in recent years include; the increasing demand for interest-free finance products around

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the world, the enforcement of related regulations, the diversification of investments, the increase in demand from conventional investors and the development of a range of products to meet individual or corporate finance demand (IFSB, 2010).

The interest-free financial system not only creates an alternative financial market but also stands out in its contribution to the sustainability of financial stability. The recent global financial crisis raised doubts about whether conventional banks are functioning properly and also brought interest-free banks under attention due to their successful performance during the crisis period (Hasan, 2010). There is widespread belief among academic and financial world that the interest-free banking system is relatively more resistant to certain types of financial shocks than the conventional banking system (Khan, 1986). Interest-free financial products are assumed to provide financial institutions with broader opportunities to meet maturity mismatches arising from long-term credit requirements with short-term resources, through partnership and risk-sharing principles (Beck, 2010). Moreover, it is claimed that the interest rate risk in interest-free banks is extremely limited because while conventional financial intermediation activities are predominantly based on debt financing and risk transfer, interest-free finance principles prohibit interest and it's expected that parties share profit and loss (Hasan, 2010).

On the other hand, there are various doubts whether interest-free financial institutions, especially participation banks, are really different from conventional financial institutions and whether these institutions operate in accordance with interest-free finance principles. Some new empirical researches strengthen these doubts. For example, strong correlation is found between participation banks' "profit share" ratios for housing loans and mortgage interest rates of the deposit banks in Turkey between 2005 and 2015. Besides that, the profit shares paid to participation accounts and deposit interest rates in the same period are highly correlated (Çetin, 2017). In this context, the distinct correlation between the yields of interest-free financial products and the market interest rates constitutes one of the most important controversial issues of today's interest-free finance system (Saraç, 2015). While such discussions directly affect the interest-free financial sector's reputation, another debate has risen: If the interest-free finance activities do not differ from the interest and other basic elements of conventional finance in a real sense, do the opinions that interest-free financial institutions be more robust and more resistant to crises than conventional financial institutions remain valid?

Theoretically, interest-free financing activities differ significantly from conventional financing activities. Interest-free finance principles do not allow interest, speculation and prohibited products to be financed. Interest-free finance is based on the idea that there is profit-loss or risk-sharing principle in both assets and liabilities, furthermore, all financial transactions are derived from real commercial activities (Beck, 2010). Essentially, the most basic feature of the concept of interest-free finance is the prohibition of interest-bearing transactions. However, there is no consensus among scholars regarding the definition and scope of "riba", which is the Arabic equivalent of interest (Khan, 1986). There are different definitions of interest in different academic sources. However, with the commonalities found in the definitions of interest in the literature, interest may be defined as a surplus in liabilities, arise due to maturity, in the form of a predetermined or committed amount or rate, in transactions that generate debt. In this context, the general opinion about interest is that "all kinds of riba are interest" (Dinç, 2016).

One of the most important differences that distinguish interest-free banking from conventional banking is the principle of "Profit and Loss Sharing" (PLS). According to the PLS principle, it is not appropriate to establish a pre-determined fixed-rate contract in any financial transaction, but instead there is a financial relationship based on a symmetric return sharing between the parties (Ergeç, 2011). Accordingly, it can be said that as the compliance with the PLS principle increases, the sensitivity to interest rates decreases. On the other side, in an interest-free financial transaction, the profit-sharing ratio between the owner of the capital and the entrepreneur can be predetermined, but this does not contradict the PLS principle (Chong and Liu, 2009).

The theoretical models of interest-free banking mainly recommend partnership contracts such as "mudaraba" and "musharaka". However, current interest-free financing practices are based largely on interest-free financial instruments which operate in a manner similar to conventional financial instruments. Majority of interest-free banking transactions are based on murabaha (cost plus sale), ijara (leasing), selem (forward sale) and istisna (manufacturing contract) contracts that are permissible under Islamic rules but do not fully comply with the PLS principle (Chong and Liu, 2009).

There are several factors that cause interest-free financial institutions to offer products which produce financial consequences similar to those of conventional products in interest based institutions. One of these factors is that, due to the withdrawal risk, interest-free banks' managers prefer to pay their customers competitive yields at market rates, regardless of actual performance (Obaidullah, 2005).

Turkish participation banks have been paid competitive profit share that converge to the market deposit interest rates in order to compete with the market conditions. Figure 1 shows average participation fund profit share rates and average deposit interest rates between January 2005 and September 2015. The figure indicates that the profit share ratios and the deposit interest rates in this period show a similar course to a great extent.

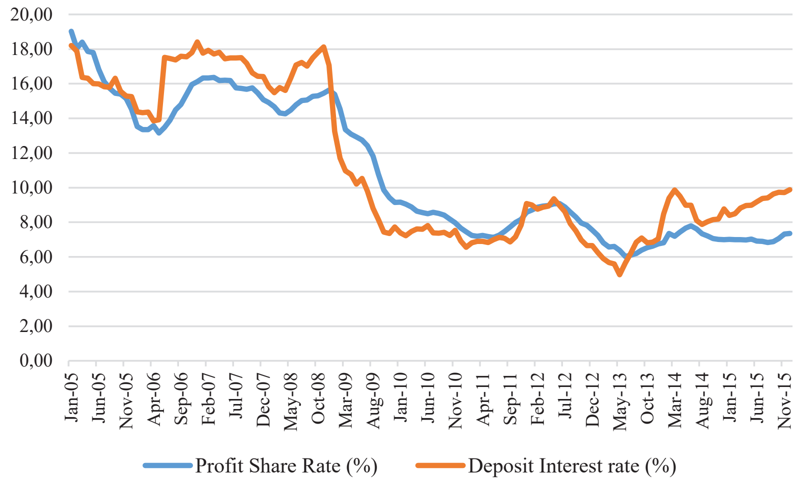

Figure 1. Average Deposit Interest Rates and Average Participation Fund Profit Share Rates in Turkish Banking Sector. Source: CBRT, http://evds.tcmb.gov.tr/

Participation banks allocate reserves from participation fund profits during periods of high returns and transfer them to low profit periods in order to be able to compete with deposit interest rates. These transfers are carried out in accordance with the third paragraph of Article 14 of the "Regulation on the Procedures and Principles for the Determination of the Qualifications of Loans and Other Receivables in Banks and Provisions" (BDDK, 2006). These amounts, which are reserved by legal provision provided by this Article, can be called "Profit Equalization Reserve ". Profit equalization reserve can be used to eliminate participation fund profit share rate fluctuations that occur between different periods. However, there is no publicly available information on how often and to what extent the participation banks have made profit transfers in order to eliminate profit fluctuations.

In addition to profit equalization reserves, another approach, which decreases compliance with the PLS principle, is to take market interest rates into account when pricing interest-free financial products. In this way, interest-free financial institutions can offer financial products that cause similar financial results to conventional products. For "murabaha" transactions, which comprise a large part of the financing activities of interest-free banks, the profit share rate is generally determined on the basis of a benchmark interest rate such as LIBOR[1]. Due to these benchmark rate fluctuations, probability of loss is called "mark-up" risk (Hussein, 2015).

On the other hand, the strict compliance with the PLS principle depends on the existence of certain conditions. For example, the level of information asymmetry in an economy and the efficiency and the demand for interest-free financing products compatible with the PLS principle are inversely proportional. Similarly, in order for financial institutions to offer long-term interest-free finance products, the risk of moral hazard and adverse selection must be minimized (Okumuş, 2012).

It is expected that there may be a relation between the level of compliance with the PLS principle and interest rate sensitivity. However, the issue of whether interest-free financial institutions are exposed to interest rate risk remains a matter of debate among both academic and financial sector.

In this study, our aim is to analyze the effect of the change in market interest rates on the profitability of the participation banks and to contribute to discussions about whether interest-free banks are exposed to interest rate risk or not. For this purpose, the Basel Committee on Banking Supervision's definition of interest rate risk in banking book (IRRBB) is taken as the basis for this research.

The interest rate risk is defined by the Basel Committee as the probability of a bank's loss as a result of market interest rate changes (BCBS, 2004). Besides, Basel Committee considers interest rate risk in two headings: "market interest rate risk" and "IIRBB". The market interest rate risk is mostly related to the probability of loss of interest-bearing capital market instruments in trading accounts. IRRBB is defined as the probability of loss that may arise in the bank's capital or income due to changes in market interest rates (Akan, 2008). Theoretically, due to interest-free finance principles, it is not possible for participation banks to have financial instruments that are exposed to market interest rate risk, such as bonds or option contracts. For this reason, in this study, it is assumed that participation banks can be exposed to only IRRBB.

According to the capital adequacy consensus known as Basel III[2], which was

1 London Interbank Offered Rate

2 International Convergence of Capital Measurement and Capital Standards

published by the Basel Committee in 2010, banks use the statistical models for calculating IRRBB. However, this kind of model has not been utilized in this study because such models and data are not shared with the public.

Previous Empirical Studies

The relationship between interest-free banks and market interest rates has been the subject of many academic researches. Although in many theoretical studies it is claimed that interest-free banks are not exposed to interest risk, empirical studies have often reached the opposite conclusions. Chong and Liu (2009) analyzed Malaysian interest-free banks by the Granger Causality Test method and found that the assets of these banks are not different from the conventional banks in terms of PLS principle and their liabilities more comply with it.

Ergeç and Gülümser (2011) analyzed the data of the Turkish participation banks for the period between 2005 and 2009 using the VAR method and found that a change in the interest rates affects the assets and liabilities of both conventional and interest-free banks.

Abedifar, Molyneux and Tarazi's (2013) regression analysis study, conducted by panel data on 553 interest-free banks in 24 different countries between 1999 and 2009 periods, shows that interest-free banks are less sensitive to interest rates than conventional banks.

It has been found by Umar and Mansur (2014), by using time series multivariate forecasting technique on the interest-free banks' data in Malaysia between 1999 and 2012 periods, that there is correlation between the market interest rates and financing of interest-free banks, and a lead-lag causality relationship.

Saraç and Zeren (2015) determined that there is strong correlation between the interest rates of conventional banks and the profit share ratios of participation banks as a result of Granger Causality Test analysis on the data of participation banks in Turkey.

The strong correlation can be attributed to the correlation of the two variables with inflation. Regarding this issue, in his empirical study, Dinç (2017) showed that inflation is among the determinants of participation banks' net profit margin and there is strong relation between profit share, interest and inflation rate.

Data and Methodology

Profitability of banks has been examined in previous empirical studies by different models and methods such as multivariable regression or data envelopment analysis. There are a number of variables such as efficiency, scale economics and macroeconomic factors that affect the profitability of interest-free banks, like other financial institutions. However, the main purpose of this study is not to analyze the profitability of interest-free banks but to investigate the relationship between profitability and interest rates and determine whether interest-free banks are exposed to interest rate risk. For that reason, study focuses on interest rate variables by ignoring other factors affecting profitability.

Statistical Method

In the study the following two null hypotheses are tested:

H_0: There is no significant relationship between the profitability of the participation banks and the market interest rates.

H_1: There is a significant relationship between the profitability of the participation banks and the market interest rates.

The analysis in this study is based on the bank's profitability and interest rate relationship model developed by Mark J. Flannery (1981). Flannery's model is based on Arnold Zellner's (1961) Seemingly Unrelated Regression (SUR) method. The SUR method has been widely used to estimate multi-equation models since the first time it was introduced. This method is called seemingly unrelated, because, at first glance across the equations, dependent variables may seem unrelated but in fact error terms are related (Brooks, 2008). In this study, although the profitability of each participation bank seems to be independent of each other, it is expected that these banks affect each other's profit share ratios and their profitability because of the competitive environment caused by the oligopolistic market conditions. Since it allows considering the potential correlations between error terms in equations, SUR method has been found appropriate for this study.

The basic idea of the SUR approach is to make error terms unrelated by transforming the model. After the correlations between the error terms in the equations in the model are removed, SUR calculation of the system of equations should become equivalent to running separate Ordinary Least Square (OLS) regression for each equation (Brooks, 2008). In this way, the SUR method allows to estimate the profitability of banks together, rather than separately estimating each bank's profitability.

The SUR method (Hill, 2011), which is essentially a generalized OLS procedure, can be described as follows. In our example, there are “m” equations that determine the profitability of “m” banks.

$$y_1 = \beta_1 x_1 + u_1$$

$$y_2 = \beta_2 x_2 + u_2$$

$$.$$

$$.$$

$$.$$

$$y_m = \beta_m x_m + u_m$$

In general notation, *i*th equation in the equations set can be written as $y_i = \beta_i x_i + u_i$. There are equal number of observations *(n)* in all of these equations, however number of explanatory variables (K_i) in an equation may be different from each other. Accordingly, y_i and u_i are a (n x 1) vector, x_i is a (n x K_i) matrix, and β_i is a (K_i x 1) vector. To combine all the equations into a single model, the vectors and matrices can be written as:

$$y_* = \begin{bmatrix} y_1 \\ y_2 \\ . \\ . \\ y_m \end{bmatrix}, \; x_* = \begin{bmatrix} x_1 & 0 & \cdots & 0 \\ 0 & x_2 & \cdots & 0 \\ \vdots & . & \ddots & \vdots \\ 00 & & \cdots & x_m \end{bmatrix}, \; \beta_* = \begin{bmatrix} \beta_1 \\ \beta_2 \\ . \\ . \\ \beta_m \end{bmatrix}, \; u_* = \begin{bmatrix} u_1 \\ u_2 \\ . \\ . \\ u_m \end{bmatrix}$$

y_* and u_* (nm x 1) vectors, x_* (nm x $\sum_{i=1}^{m} K_i$) matrix and β_*($\sum_{i=1}^{m} K_i$ x1) vector can be shown in one single equation; $y_*=\beta_* x_*+u_*$ (Vogelvang, 2005).

There are three stages in the estimation procedure of the equation with SUR method;

1. Each equation is estimated separately using the OLS method.
2. The variances of the estimators and the covariance of the model are calculated by using residuals obtained by the OLS estimates.
3. Using the estimates obtained in the second stage, all equations are estimated jointly in a generalized OLS framework (Hill, 2011).

There are commands in the econometrics software that automatically calculate these three stages. In this study, “STATA” software is used for estimation with SUR method.

Model

The main reason for using Flannery's model to determine whether participation banks are exposed to interest rate risk is that the model is based on market interest rate changes as a key factor in determining bank profitability. According to the model, the economic value of a bank is determined as follows:

$$V_t = \sum_{t=1}^{\infty} \frac{R_t - C_t}{(1 + r_t)^t}$$

where;

V_t: Current market value of the bank's equity,

R_t: Total operational revenues,

C_t: Total operational costs,

r_t: Discount rate.

According to the Flanner's equation, the main source of bank profitability is the difference between operational revenues and expenses. In other words, the source of profitability is the difference between interest income and interest expenses. Figure 2 shows the development of the interest and non-interest income of the Turkish Banking Sector over the last ten years. The figure indicates that net non-interest incomes are lower than net interest incomes. The graph shows that net non-interest incomes are lower than net interest incomes. Moreover, while net profit is positive, net non-interest income is negative in various periods. Therefore, net interest income is the main factor that determines the profitability of the Turkish banking sector. In this respect, the development of the profitability of the Turkish banking sector supports Flannery's approach.

However, in this study, unlike Flannery's model, net profit share income of participation banks is taken as a profitability indicator instead of net interest income. Net profit share income refers to margin between returns of participation banks' loans and the profit share paid to participation funds. In this context, "profit share margin" in participation banking and "net interest margin" in conventional banking have the same meaning. Besides, Figure 3 shows that the main factor that determines the total profitability of participation banks is net profit share income. In this respect, the use of the profit share ratio instead of the interest rate is appropriate for the general logic of the model.

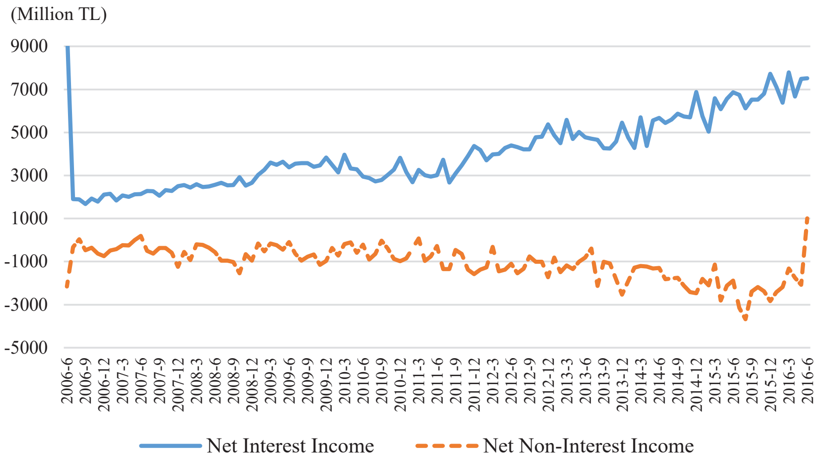

Figure 2: Development of Turkish Banking Sector Net Interest Income and Net Non-Interest Income[3], Source: BRSA Interactive Monthly Bulletin. http://ebulten.bddk.org.tr/ABMVC/en/Gosterim/Gelismis

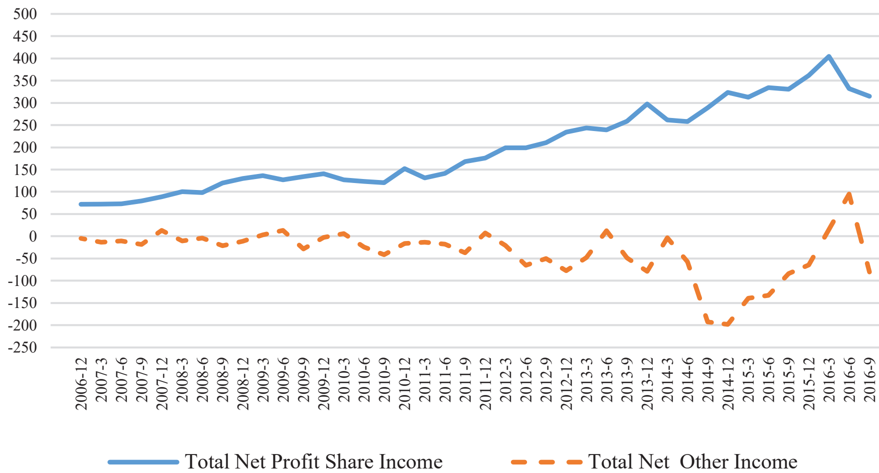

Figure 3: Development of Net Profit Share Income and Net Other Income of Turkish Participation Banks.

Source: BRSA Interactive Monthly Bulletin, http://ebulten.bddk.org.tr/ABMVC/en/Gosterim/Gelismis

3 The graph is prepared by calculating the monthly developments of cumulative net interest incomes and net non-interest incomes from the data of the BRSA interactive monthly bulletin. Net interest income amounts include participation banks' net profit share incomes.

The relationship between the profitability of the banks and the market interest rates is estimated by the following model:

$$\frac{NCOE_t}{TA_{(t-1)}} = \beta_0 + \beta_1 \left(\frac{NCOE_t}{TA}\right)_{t-1} + \beta_2 r_t + \beta_5 \sigma_{r\,t}^2 + \beta_4 \left[r_t \left(\frac{TA_t - TA_{t-1}}{TA_{t-1}}\right)\right] + \varepsilon_t$$

The dependent variable in the model is the "bank profitability" value, which is calculated by dividing the present values of the net operating profits of banks by their total assets. Where;

NCOE : Net Profit From Profit Sharing Activities, (R_t - C_t),(R_t: Profit Share Income, C_t : Profit Share Paid),

r_t: Benchmark Interest Rate,

$\sigma_{r(t)}$: Volatility of Benchmark Interest Rate,

TA : Total Assets.

One of the difficulties in this study is to determine the benchmark interest rates. There may be more than one benchmark interest rates affecting the cost of the financial products of the banks. Furthermore, banks may offer different interest or profit share ratios for each financial product according to criteria such as maturity, customer type or tax rate. Banks may consider different market indicators due to their business strategies, while they determine the ratios of their financial products. For example, for housing loans the lowest rate of government securities and for consumer loans the highest rate can be taken as benchmark rate. Besides the market benchmark rates, the rates offered by other banks or the equity structure of banks and alternative costs are effective in determining the ratios of financial products. Therefore, it is not possible to set one single market interest rate that determines the cost of bank liabilities and the incomes of loans. As a consequence, any benchmark rate that can be taken as an explanatory variable can be statistically insignificant for a bank, while producing a significant result for another bank. For that reason, in this study, all possible market interest rate data are tested for each bank, and interest rates with significant result are selected as explanatory variables.

Dependent and independent variables in the model:

Yi = NCOE/TA_{t-1} ; (Profit Share Income – Profit Share Costs)/Total Assets of Previous Periods

DTA_i = r_t ((TA_t – TA_{t-1})/TA) ; Change in total assets (discounted with benchmark rate)

IMR = Change in interest rate margin between loan and deposit
ADR = Monthly Average Deposit Interest Rate (discounted with inflation rate)
VAR = Variance of benchmark rate.

Data

The data on total assets, profit share income and expenses of the four participation banks operating in the period 2005-2016 has been obtained from the Turkish Participation Banks Association and participation banks' websites. The Ziraat Participation Bank, which came into operation in November 2014 and the Vakif Participation Bank which was established in February 2016, are not included because of insufficient data. The loan-deposit interest rates data are obtained from The Central Bank of Turkey database and the average monthly deposit interest rates are obtained from the Turkish Statistical Institute.

The descriptive statistics of the time series used in the study are given in Table 1:

Table 1
Descriptive Statistics of Variables

Variable	Max	Min	SD	Mean
Y1	0,6854	0,1307	0,1269	0,3407
Y2	0,7377	0,0235-	0,1690	0,3501
Y3	0,4967	0,1864-	0,1414	0,3150
Y4	0,5899	0,2762	0,0918	0,3815
DTA1	0,0806	0,0778-	0,0290	0,0001
DTA2	2,0726	0,7997-	0,6173	0,1520
DTA3	1,6033	0,3289-	0,4517	0,2454
DTA4	1,4263	0,5767-	0,4413	0,3364
ADR	7,7600	4,6200-	2,7801	1,5000
IMR	1,7250	1,8625-	0,6783	0,0350-
Var	9,3396	0,1154	2,4861	1,5884

Empirical Results

The data series must be stationary in order to be able to perform analysis with SUR method. Augmented Dickey Fuller (ADF) and Philips–Peron procedures are applied to test the null hypothesis of unit root against the alternative hypothesis of stationarity. Table 2 shows summary of the unit root test results:

Table 2
Unit Root Tests Summary Results

Variable	ADF				Phillips Perron			
	Intercept		Trend and Intercept		Intercept		Trend and Intercept	
	t-Stat Value	% 5 Critic Value	t-Stat Value	% 5 Critic Value	t-Stat Value	% 5 Critic Value	t-Stat Value	% 5 Critic Value
Y1	-2,98	-2,93	-5,43	-3,52	-4,30	-2,93	-5,40	-3,52
Y2	-1,31	-2,93	-4,15	-3,52	-0,73	-2,93	-4,18	-3,52
Y3	-4,14	-2,93	-4,33	-3,52	-5,68	-2,93	-4,33	-3,52
Y4	-1,99	-2,93	-3,99	-3,52	-1,82	-2,93	-4,33	-3,52
DTA1	-6,94	-2,93	-7,09	-3,52	-6,95	-2,93	-7,10	-3,52
DTA2	-3,27	-2,93	-4,60	-3,52	-3,16	-2,93	-4,63	-3,52
DTA3	-5,32	-2,93	-6,05	-3,52	-5,37	-2,93	-6,05	-3,52
DTA4	-4,08	-2,93	-4,74	-3,52	-3,93	-2,93	-4,84	-3,52
ADR	-5,28	-2,93	-5,42	-3,52	-5,15	-2,93	-5,33	-3,52
IMR	-6,08	-2,93	-6,06	-3,52	-6,06	-2,93	-6,04	-3,52
VAR	-5,09	-2,93	-5,09	-3,52	-5,07	-2,93	-5,10	-3,52

The t statistic values for all variables are less than the 5% significance level critical values. According to this, the null hypothesis is rejected and the data series are stationary.

The SUR method needs to have some additional assumptions, along with the basic assumptions of the generalized OLS (Conniffe, 1982). One of the main assumptions of the SUR method is the correlation between the error terms of the equations in the same time period. If there is no such relationship, using SUR instead of generalized OLS will not be appropriate (Brooks, 2008). Breusch-Pagan Lagrange Multiplier test is used to test the null hypothesis of "there is no correlation between the units" against alternative hypothesis of "there is correlation between the units" (Tatoğlu, 2013). Table 3 shows that correlation matrix of residuals of the model and the results of the Breusch-Pagan Lagrange Multiplier test.

Table 3
Correlation Matrix of Residuals and Breusch-Pagan Lagrange Multiplier Test

	Albarakaturk	Banksasya	Kuveytturk	Türkiye Finans
Albarakaturk	1.0000			
Banksasya	-0.1610	1.0000		
Kuveytturk	0.2888	-0.0014	1.0000	
Türkiye Finans	0.2060	0.0237	0.3935	1.0000
Breusch – Pagan test of independence: chi2 (6) = 13.822, Pr = 0.0317				

The chi2(6) = 13,822 (Prob. = 0,0317) value, obtained from the Breusch-Pagan test, shows that the null hypothesis is rejected and the correlation between units exists. This means SUR method is appropriate for estimating the model.

The model to be estimated is as follows:

$$Y_1 = \alpha_0 + \alpha_1 Y_{1(t-1)} + \alpha_2 ADR + \alpha_3 DTA_1 + \alpha_4 VAR + u_t$$

$$Y_2 = \beta_0 + \beta_1 Y_{2(t-1)} + \beta_2 IMR + \beta_3 DTA_2 + \beta_4 VAR + \varepsilon_t$$

$$Y_3 = \gamma_0 + \gamma_1 Y_{3(t-1)} + \gamma_2 IMR + \gamma_3 DTA_3 + \gamma_4 VAR + \omega_t$$

$$Y_4 = \theta_0 + \theta_1 Y_{4(t-1)} + \theta_2 IMR + \theta_3 DTA_4 + \theta_4 VAR + \nu_t$$

Where;

$$Y_1 = \left(\frac{NCOE}{TA_{t-1}}\right)_{Albaraka}, Y_2 = \left(\frac{NCOE}{TA_{t-1}}\right)_{Bankasya}, Y_3 = \left(\frac{NCOE}{TA_{t-1}}\right)_{Kuveyttürk} \text{ ve } Y_4 = \left(\frac{NCOE}{TA_{t-1}}\right)_{TürkiyeFinans}$$

Another assumption of the SUR method is that there is no autocorrelation. The null hypothesis of "there is autocorrelation" is investigated by Portmanteu Test. Its results are shown in Table 4.

Table 4
Portmanteu Test for Autocorrelations

System Residual Portmanteau Tests for Autocorrelations
Null Hypothesis: no residual autocorrelations up to lag h
Date: 07/11/17 Time: 08:44
Sample: 2005Q4 2016Q3
Included observations: 44

Lags	Q-Stat	Prob.	Adj Q-Stat	Prob.	df
1	25.17355	0.0668	25.75898	0.0575	16
2	38.23680	0.2072	39.44429	0.1714	32
3	57.18578	0.1709	59.77978	0.1184	48
4	75.72440	0.1498	80.17226	0.0835	64
5	92.89090	0.1536	99.53959	0.0686	80
6	99.27522	0.3891	106.9320	0.2094	96
7	110.7736	0.5150	120.6057	0.2725	112
8	119.9689	0.6812	131.8444	0.3899	128
9	132.9223	0.7359	148.1287	0.3897	144
10	146.1085	0.7772	165.1932	0.3728	160
11	159.1761	0.8136	182.6167	0.3506	176
12	172.0016	0.8471	200.2517	0.3267	192

According to Portmanteu autocorrelation test, the null hypothesis is rejected because the prob. values obtained for all lags are greater than 0.05, hence, there is no autocorrelation in the model.

After testing the assumptions, the estimation results of the model with the SUR method are presented below.

Table 5
Seemingly Unrelated Regression Estimation Results

Equation	Obs	Parms	RMSE	"R-sq"	chi2	P
Albarakaturk	45	4	.103049	0.2040	17.61	0.0015
Bankasya	45	4	.0809245	0.7195	126.58	0.0000
Kuveytturk	45	4	.1030729	0.2783	19.51	0.0006
Türkiye Finans	45	4	.0488644	0.6883	115.48	0.0000

	Coef	Std. Err.	z	P>|z|	[95% Conf.	Interval]
Albarakaturk						
Y11	.1231014	.0806355	1.53	0.127	-.0349412	.2811441
DTA1	.0069544	.6274408	0.01	0.991	-1. 222807	1.236716
ADR	.0157341	.0059125	2.66	0.008	.0041498	.0273224
Var	.0128498	.0068073	1.89	0.059	-.0004524	.0281919
_cons	.2727856	.0381916	7.14	0.000	.1979315	.3476397

Bankasya						
Y22	.8364554	.1090981	7.98	0.000	.6305454	1.042365
DTA2	.0559795	.0262178	2.14	0.033	.0045936	.1073655
IMR	-.0399882	. 020934	-1. 91	0.098	-.0810181	.0010418
Var	-.0043878	. 0054563	-0.80	0.421	-.015082	.0063063
_cons	.0457057	.0413847	1. 20	0.230	-.0314068	.01308182
Kuveytturk						
Y33	.0916497	.1018663	0.90	0.368	-.1080047	.291304
DTA3	.0612247	.0359463	-1.70	0.089	-.1316781	.0092286
IMR	-.0929471	. 0262862	-3.54	0.000	-.1444671	.0414271
Var	-.0102337	. 0068352	1.50	0.134	-.003163	.0236304
_cons	.264479	.0411336	6.43	0.000	-.1838586	.3450994
Türkiye Finans						
Y44	.668032	.077058	8.67	0.000	.5170012	.8190628
DTA4	.0373606	.0211657	1.77	0.078	-.0041235	.0788446
IMR	.0249569	. 012618	1.98	0.048	.0002261	.0496877
Var	-.0033972	. 0035765	0.95	0.342	-.0036126	.010407
_cons	.1066698	.0312584	3.41	0.001	.04540044	.1679352

The overall results of the SUR show that the Wald statistic (Chi2) prob. values are smaller than 0.05 for all equations, meaning that the model is significant at the 5% significant level. In addition, the "R-sq" ratios, which indicates the level of explanation of the profitability of participation banks by the market interest rates, are 71.95% for Bankasya, 81% for Turkiye Finans Bank, 27.83% for Kuveyt Türk Bank and 20.4% for Albaraka Türk Bank .It can be argued that there is a stronger relationship between market interest rates and the profitability of banks with high R-sq ratios, and that these banks are exposed to more interest rate risk than banks with the low R-sq. The variable of average monthly deposit interest rate changes that explains changes in the profitability of Albaraka Türk Bank is statistically significan. And the variable of changes in loan-deposit interest rate margin, for other three participation banks, is statistically significant. It is concluded from the results of the model estimated by SUR method that there is a significant relationship between the profitability level of the participation banks and the market interest rates and that this relationship is stronger for the Bankasya and Türkiye Finans Participation Banks.

Conclusion

Interest-free banks, unlike conventional banks, do not commit to pay principal, interest or similar returns for the funds they collect. For this reason, it is claimed that the banks are not subject to interest rate risk. However, many studies show that interest-free banks operate by taking in consideration the market interest rates. In order to determine whether interest-free banks are exposed to interest rate risk, it is important to determine the relationship between the financials of interest-free banks and the market interest rates.

In this study, the relation between the market interest rates and profitability of four Turkish participation banks for the period between 2005 and 2016 has been examined by the "Seemingly Unrelated Regression" method. As a result of the regression analysis, it is found that there is a significant relation between the profitability of the participation banks and the interest rate changes. This result indicates that the institutions are exposed to interest rate risk. However, the degree of the relationship with market interest rates differs for each bank. Therefore, when analyzing the interest rate risk of interest-free banks, a new approach should be developed which also takes into account the relationship between profitability and interest rate.

The main reason for the interest rate risk exposure of interest-free banks is to take market interest rates into consideration by mechanisms such as "profit balancing reserve" or "benchmark rate" when determining price of products. However, exposure to interest rate risk does not contradict Islamic finance principles, as expressed in many sources in the literature. Interest-free banks receive opinions and approval from competent and qualified persons in the field of interest-free finance for their transactions (Khan, 2015). Nonetheless, interest-free finance practices are based on the concept of "sharing", as is often stated in the literature. The preference of financial products, that take market interest rates into account instead of share based approach, reduces the degree of compliance with the "Profit Loss Sharing" principle.

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Do Islamic Banking Standards Convey More Financial Transparency than Conventional Banking Ones?

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Abstract: This study examines the criteria of transparency and disclosure in Islamic banking and compares them to conventional banking. By examining the traditional accounting standards for transparency, namely IAS 1, IAS 24, IFRS 7 along with the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards, we have highlighted that despite the fact that the conventional banking strives to achieve transparency; there is a lack of optimal transparency in conventional banking products. This deficiency is caused by the lack of the determination of the rate of change of interest and the variable interest loans, the securitization and the sale of the debt. This leads to a lack of transparency of all important financial and non-financial information, lack of disclosure in the balance sheet such as bankruptcy and the real characteristics of traded financial instruments. Nevertheless, the principles of Islamic finance, such as the prohibition of *riba* and *gharar* as well as the link to the real economy emphasize transparency in Islamic banking transactions. Hence, AAOIFI advocates high transparency. Besides the conventional disclosure, there is a disclosure on the basis of the distribution of revenues, the determination of selling prices and the statement of the illegitimate part of bank activity. Furthermore, by considering a sample of AAOIFI accounting standards 2 related Murabaha, to the Purchase Order and comparing it to conventional loans, we have concluded that financial transparency is more enforced in Islamic banking than in conventional one. Transparency protected the Islamic banking transactions from falling into the *subprimes* crisis.

Keywords: Islamic Banking, Transparency, Disclosure, Conventional banking, Standards, AAOIFI, Murabaha

JEL Codes: E42, G14, G21, Z12.

Introduction

The financial crisis of 2008 has caused suspicion on the rules and regulatory foundations of the conventional financial system (De Mendonça et al, 2010). For instance, hiding of information is among relevant factors leading to the emergence of this crisis as it is responsible for the non-disclosure of financial institutions' risks causing bad assessment of their financial health.

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Notably, the lack of transparency of information regarding market prices and credit instruments, excessive gambling, lack of financial disclosure and failure to apply proper governance led to the *subprimes crisis*. In this respect, Kane (2009) noted that this crisis reflected a lack of transparency (e.g. extremely lax securitization practices) in some banks. Furthermore, Stiglitz (2009) indicates that there is no surprise of the bank run occurrence due to the lack of transparency. In their study, "What is the importance of regulation and transparency in the subprime crisis?" De Mendonça et al (2010) conclude that countries with greater transparency and regulation of their financial sector have experienced a lower effect of the subprime crisis.

In this context, both researchers and authorities look for effective mechanisms to enhance financial transparency to limit the occurrence of such crisis. Thus, the promotion of transparency becomes more necessary to control not only the financial institutions but also for the integrity of the financial system. Transparency is one of the fundamental rules of governance. It ensures the financial institution management's obligation not to adopt improper or illegal conduct by monitoring and auditing published information (Benjamin, 2014). Besides, as argued by Akhigbe et al (2017), transparency expands the market for a bank's stock, lowers the cost of capital and improves a bank's financial performance.

As Islamic banks were spared by this crisis, many research works investigate the specificities of Islamic financing compared to the conventional one (e.g. Dridi and Hasan (2010), Beck et al. (2013), Boukhris and Nabi (2013)). The financial transparency advocated by Islamic Banks is among the specified explanations of their resilience to this crisis. So, the specific research objective is to examine the differences in financial transparency standards between Islamic and conventional financing. This paper compares the transparency standards and their application in Islamic and conventional banking to address the accounting transparency issue by considering *Murabaha* as a case study.

The remainder of this paper is as follows: the second section presents financial transparency in conventional banking and focuses on transparency standards. The third section examines the transparency standards of the Islamic banking. The comparison between Islamic financial transparency standards and conventional one is done in fourth section considering the sample of *Murabaha* to the Purchase Order as a case study of accounting issues. Finally, we conclude the work with some policy recommendations.

Financial Transparency in Conventional Banking

The financial meltdowns experienced by many international companies show shortcomings in the disclosure of financial reports, in the quality of audit reports and also an imbalance in the rights of managers and shareholders (Khalil and Ashmaoui, 2008).

In *Subprimes* crisis, most of the loans are granted to low solvency customers. Moreover, they were variable rate loans up to 8 percent of the FED interest rate. Yet, the Federal Reserve rate, which was close to 1 percent during 2002-2004, had gradually increased to 5 percent at the end of 2006 (Pozen, 2009). As a result, the beneficiaries of the loans were not able to repay their installments (93% of borrowers). Furthermore, the securitization of mortgage loans and their selling in financial market aggravated the problem. For instance, the asset securitization was characterized by ambiguity in the dissemination of information between the lender and the borrower (Keys et al, 2009).

Many accounting organizations have stressed the need to respect the principle of full disclosure and have pointed out the conditions to meet it. Among these organizations, we can cite the American Institute of Certified Public Accountants (AICPA), founded in 1939; which established accounting principles or standards of financial accounting and *Securities and Exchange* Commission (SEC) in 1972 (Gibson, 2013). Nevertheless, due to differences in accounting procedures between countries particularly in European countries, the International Accounting Standards Committee (IASC) was founded in 1973 to establish uniform accounting standards in all countries through 'International Accounting Standards' IAS (Kimura and Ogawa, 2007) and later in 2002, 'International Financial Reporting Standards' IFRS, which urges transparency standards.

Financial disclosure and transparency

There is a close relationship between the concept of transparency and the concept of disclosure. Both meet in the transmission of knowledge or the transfer of information from the source of production to its users or beneficiaries (Aboud, 2009). However, there are differences, and it is difficult to distinguish between them.

Differences between transparency and disclosure

Transparency is the general disclosure of renewable and honest information which enables users of information to accurately assess firm's status, financial performance, activities, risk setting and risk management practices.

In order to achieve transparency, it is necessary to provide adequate disclosure of quantitative and qualitative information which enables users to have appropriate assessments of institutions' activities and their risk's situations (Kantakji, 2012). So, the disclosure does not lead to transparency just by itself.

For financial institutions, transparency is the full and immediate disclosure of all information of the financial institution to all interested parties (outside of the institution). Bushman (2016) argues that "Bank transparency can be defined as the availability to outside stakeholders of relevant, reliable information about the periodic performance, financial position, business model, governance, and risks of banks".

According to Christina (2003), the concept of transparency is defined regarding the following features:

- Clarity: the information does not contain hidden meanings
- Integration: the information clarifies the relationship between decisions and other activities
- Access: allowing everyone to access and receive documents and lead to dialogue between decision-makers and others.
- Truth and accuracy: information is free from deceit

In general, disclosure is the transmission of knowledge or the transfer of information from the source of its production to those who use it or who can benefit from its use. Disclosure is a deliberate transfer of information to those who do not know it (Essaben, 1996). Nevertheless, unlike transparency, the disclosure is not only a matter of providing data and information and allowing access to it, but the firm is required to provide and deliver information on a regular basis and also carry it to all shareholders, public and even potential investors.

In order to achieve transparency, many characteristics should be checked in the information presented in the financial statements (Transparency International, 2011):

- Truthful: Disclosure should be based on information that accurately describes the financial condition of the institution.
- Comprehensiveness: Disclosure information should answer all inquiries in order to enable investors to make informed decisions and must include financial and non-financial matters.
- Importance: The disclosed information should be relevant and have an impact on evaluation and investment decision.

- Timing: Disclosure information should be presented in a timely fashion to enable investors to interact as quickly as possible, before losing the ability to influence decisions.
- Availability: Information disclosed should be readily available to all investors at a low cost.

Thus, it is necessary to provide accurate and sufficient disclosure whether quantitative or qualitative in the financial statements or in appendix, notes and supplementary tables in appropriate time.

Transparency objectives

Transparency is of great importance in the financial markets and for the whole economy. It contributes to disclosure of all information that will ensure the proper accountability of institutions, investors, shareholders, regulators and other stakeholders. Transparency allows for more realistic future expectations, and consequently a better pricing of all financial assets regarding the organization. It reduces asymmetric information in the market. Among most important objectives of transparency in financial systems, we note (Transparency International, 2011):

- Fighting fraud and corruption in financial institutions.
- Improving the efficiency through pricing and cost detection and ensuring equal opportunities and fair market conditions in general.
- Protecting investors by removing ambiguity and discrepancies of information and permitting an effective risk analysis.

Transparency Standards in Conventional Banking

Accounting is the process of identifying, measuring and recording business transactions in order to establish financial reporting and facilitate the decision making. International Accounting Standards Board (IASB) aims to develop a unified set of high-quality accounting standards which can be applicable in worldwide. International accounting standards emerged in 1972 with the establishment of International Accounting Standards Committee (IASC) for nine countries. The Commission was restructured in 2001 and became International Accounting Standards Board (IASB). Its objective is to develop high-quality standard, comprehensible and enforceable disclosure of financial statements for all countries thus it provides accounting standards at a global level. Since 1975, IASB has set 41 standard accounting (IAS).

Table 1 International Accounting Standards
- IAS 1: Presentation of Financial Statements
- IAS 2: Inventories
- IAS 3: Consolidated Financial Statements (Superseded in 1989 by IAS 27 and IAS 28)
- IAS 4: Depreciation Accounting (Withdrawn in 1999)
- IAS 5: Information to be Disclosed in Financial Statements (Superseded by IAS 1 effective 1 July 1998)
- IAS 6: Accounting Responses to Changing Prices (Superseded by IAS 15, which was withdrawn in December 2003)
- IAS 7: Statement of Cash Flows
- IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 9: Accounting for Research and Development Activities (Superseded by IAS 38 effective 1 July 1999)
- IAS 10: Events after the Reporting Period
- IAS 11: Construction Contracts
- IAS 12: Income Taxes
- IAS 13: Presentation of Current Assets and Current Liabilities (Superseded by IAS 1 effective 1 July 1998)
- IAS 14: Segment Reporting
- IAS 15: Information Reflecting the Effects of Changing Prices (Withdrawn December 2003)
- IAS 16: Property, Plant and Equipment
- IAS 17: Leases
- IAS 18: Revenue
- IAS 19: Employee Benefits (1998), (Superseded by IAS 19 (2011) effective 1 January 2013)
- IAS 19: Employee Benefits
- IAS 20: Accounting for Government Grants and Disclosure of Government Assistance

- IAS 21: The Effects of Changes in Foreign Exchange Rates
- IAS 22: Business Combinations (Superseded by IFRS 3 effective 31 March 2004)
- IAS 23: Borrowing Costs
- IAS 24: Related Party Disclosures
- IAS 25: Accounting for Investments (Superseded by IAS 39 and IAS 40 effective 2001)
- IAS 26: Accounting and Reporting by Retirement Benefit Plans
- IAS 27: Separate Financial Statements (2011)
- IAS 27: Consolidated and Separate Financial Statements (Superseded by IFRS 10, IFRS 12 and IAS 27 (2011) effective 1 January 2013)
- IAS 28: Investments in Associates and Joint Ventures (2011)
- IAS 28: Investments in Associates (Superseded by IAS 28 (2011) and IFRS 12 effective 1 January 2013)
- IAS 29: Financial Reporting in Hyperinflationary Economies
- IAS 30: Disclosures in the Financial Statements of Banks and Similar Financial Institutions (Superseded by IFRS 7 effective 1 January 2007)
- IAS 31: Interests in Joint Ventures (Superseded by IFRS 11 and IFRS 12 effective 1 January 2013)
- IAS 32: Financial Instruments: Presentation
- IAS 33: Earnings Per Share
- IAS 34: Interim Financial Reporting
- IAS 35: Discontinuing Operations (Superseded by IFRS 5 effective 1 January 2005)
- IAS 36: Impairment of Assets
- IAS 37: Provisions, Contingent Liabilities and Contingent Assets
- IAS 38: Intangible Assets
- IAS 39: Financial Instruments: Recognition and Measurement (Superseded by IFRS 9 where IFRS 9 is applied)
- IAS 40: Investment Property
- IAS 41: Agriculture

IRFS standards

Since 2003, International Financial Reporting Standard (IFRS) published 15 standards for financial information. The most important are: IRFS 1: First time adoption of international financial reporting standards, IRFS 3: Business combinations, IRFS 5: Noncurrent assets held for sale and discontinued operations, IRFS 6: Exploration and evaluation of Mineral resources, IRFS 7: Financials instruments : disclosures, IRFS 8 : Operating segments, and IRFS 9 : Financial instruments.

Table 2
International Financial Reporting Standards

IRFS 1: First-time Adoption of International Financial Reporting Standards
IRFS 2: Share-based Payment
IRFS 3: Business Combinations
IRFS 4: Insurance Contracts
IRFS 5: Non-current Assets Held for Sale and Discontinued Operations
IRSF 6: Exploration for and Evaluation of Mineral Resources
IRFS 7: Financial Instruments: Disclosures
IRFS 8: Operating Segments
IRFS 9: Financial Instruments
IRFS 10: Consolidated Financial Statements
IRFS 11: Joint Arrangements
IRFS 12: Disclosure of Interests in Other Entities
IRFS 13: Fair Value Measurement
IRFS 14: Regulatory Deferral Accounts
IRFS 15: Revenue from Contracts with Customers

We focus on the accounting standards related to transparency which are:

IAS 1[1] : "First-time Adoption of International Financial Reporting Standards": IAS 1 requires to disclose information about financial statements related to fixed assets, inventory, financial assets, capital, reserves, cash rates, equity and bond investments, profits and losses, financing costs and revenue. This ensures the com-

1 IAS 1 was reissued in September 2007 and applies to annual periods beginning on or after 1 January 2009.

parability with the firm's financial statements in prior periods. In this standard, disclosures vary for each item, for example:

- Detailing items of property, plant and equipment are classified in accordance with IAS 12.
- Detailing amount of due debtors amounts from commercial customers and those due from related parties and advance payment in addition to detailing these accounts according to the nature of finance, general conditions and general disclosures that enable beneficiaries to differentiate accounts of different debtors.
- Detailing allocations for employee benefits and other items
- Disclosing capital and reserves in various categories such as paid capital, share premium and reserves.
- Disclosure of financial assets (including cash and investments) according to their nature and general terms[2]
- Profit or loss items should be disclosed for these items: Revenue, Earning and Loss arising from not recognizing financial assets, financing costs, share of profit or loss of competing enterprises and joint ventures, and tax expense.
- The revenues of the firm must be disclosed in detail.
- Financing costs or interest expense arising from loans and bonds.

Thus, IAS 1 improves the quality of published financial statements for all institutions applying international standards.

IAS 24 "Related Party Disclosures"

According to this standard, the firm's financial statements "contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments with such parties".

2 * Cash
* Rates of cash, time deposits and due amounts detailed according to their nature and general terms
*Equity investments detailed into direct investments, investments in portfolios and investment funds, as well as investments in bonds
*Financial liabilities include overdrafts, creditors and other financial liabilities such as required payable amounts.

This standard includes disclosure of relationships between the firm and its subsidiaries. Each entity discloses the name of the entity to which it is a party. The entity shall disclose the compensation of the key management in total and for each of following categories: short-term employee benefits; post-employment benefits; other long-term benefits; termination benefits and share-based payment. In sum, this standard permits to ascertain the extent to which the financial position of a firm is affected by the existence of relationships and transactions with related parties. It discloses the nature of these relationships and the nature, components and types of transactions.

IFRS 7 "Financial Instruments: Disclosures"

The objective of IFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate: (a) the significance of financial instruments for the entity's financial position and performance; and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

Information should also integrate:

- Guarantee: The entity discloses the amounts recorded for financial assets as collateral for liabilities, terms and conditions relating to asset's issue for the mortgage.
- Accounting Policies: The entity discloses accounting policies and information in conformity with the standard of the preparation of the financial statements and accounting policies.
- Hedge accounting: The firm discloses each type of hedge. The specific financial instruments are described as hedging instruments and the nature of the hedged risks is disclosed.
- Fair value: The entity discloses the fair value of each financial asset and liability as well as the division of assets and liabilities into categories.
- Nature and extent of risks arising from financial instruments: the firm must disclose information that enables users of financial statements to assess the nature and the extent of risks arising from financial instruments.
- Qualitative Disclosures: An entity must disclose:
    - Risk exposure and how it is established.

- Objectives, policies and methods of measure and managing these risks.
- Any changes in paragraph (a) and (b) for the prior period.

- Quantity Disclosures

  It consists of disclosed entity's exposure to each type of risk arising from the financial instrument by indicating digital data for risk exposure. In addition, a firm is required to disclosing the concentration of risks arising from financial instruments and how they are managed. These risks include but are not limited to credit risk, liquidity risk, and market risk[3].

In order to enable the users of financial statements to properly assess financial instruments, IFRS 7 discloses the nature and the extent of risks arising from these instruments, financial assets and liabilities, accounting policies, measurement methods and the fair value of assets and liabilities. Disclosures should also include qualitative disclosures through risk identification and risk management techniques, and quantitative disclosures through the introduction of digital data on risk exposure, risk concentration and risk management.

Assessment of financial transparency

Financial transparency and disclosure in traditional finance are means of controlling all activities and combating internal corruption in banks.

Basel Committee considers transparency as an essential element of the system's strength and the integrity of the financial system. Basel II and Basel III recommend paying attention to market discipline and encourage fair application by increasing the degree of disclosure and transparency of Central Bank and its customers, especially with regard to capital, bank risks and the requirements of debts, sale and securitization of debts.

3 Cash
* Rates of cash, time deposits and due amounts detailed according to their nature and general terms
*Equity investments detailed into direct investments, investments in portfolios and investment funds, as well as investments in bonds
*Financial liabilities include overdrafts, creditors and other financial liabilities such as required payable amounts.
*Statement of profit and loss and property.
*It is required to disclose of the methods and assumptions used in the preparation of sensitivity analysis, as well as the changes in methods and assumptions used compared to previous periods and the reasons for these changes

Despite this attention to transparency and disclosure, there are issues which are not addressed in these standards, such as transparency through the dissemination of information about the process of securitization of intangible assets. In addition, it was stated that interest rates are often variable in loans, so, there is a lack of transparency related to the change of rate interest over the duration of the loan. In reality, the 2008 crisis has been a conclusive evidence of the lack of transparency practice in debt repayment as well as problems of securitization and sale debt.

Furthermore, the imperfections of transparency are related to the existence of problems such as misty data, ambiguity, facts blurring and falsification, double standards, vague words, difference in accounting principles, and job terrorism (Khedhery, 2005). Precisely, many financial transactions are suffering from lack of transparency (Khouja, 2013):

- Future sales of securities in the stock market are the highest speculative securities. They capture the differences resulting from fluctuations in the spot prices, whether profit or loss in the accounts of customers, but without delivering information about the shares to the buyer, the price of the seller and the real ownership of the contracted goods, these transactions suffer from lack of transparency.
- Selling securities without being the owner and making contracts on non-existent or non-owned goods causes several risks.
- Release imaginary transactions and symbolic sales by securitizing intangible assets which are difficult to assess.
- The lack of disclosure in the balance sheet, which lead to covering cases of bankruptcy in order to achieve personal interests at the expense of those who hid information. So, bad debts are traded.

Financial transparency in Islamic banking

Since the 1970s Islamic banks have emerged followed by Islamic investment companies, Takaful companies, Islamic investment funds and Sukuk. These institutions constitute Islamic financial industry with its philosophy, principles, bases, contracts and products. Islamic finance imposes various controls, procedures and standards, including *Shariah* standards, Accounting standards, risk management standards, governance standards and auditing standards (Khouja, 2013).

According to Standard & Poor's (2015), Islamic financial institutions assets were estimated at USD 1.57 trillion by the end of 2015. The global Islamic Financial Services Industry (IFSI) sustained its total assets value at approximately USD 1.9 trillion in 2016.

Globally, Islamic economy requires a higher degree of clarity and transparency (Beni Salema and Draghma, 2014). The question is if the resilience of Islamic finance to the crisis of 2008 is related to its higher transparency which distinguishes it from conventional financing? Islamic finance provides financing services in accordance with Islamic *Sharia*. It is based on (Kammer et al, 2015):

The prohibition of interest and usury which means the prohibition of the "increase of debt against the term". This provides more transparency in Islamic financial transactions compared to conventional ones since the change of interest rate does not allow the precise monthly installments and so the amount which will be paid definitively. Furthermore, the debt scheduling process leads to an inability to pay premiums and leads to more exposure to the risk of default and bankruptcy.

- The prohibition of illicit gains related to futures sale of securities in the stock market, such as short selling and buying on the margin leading to speculative transactions where there is no transparency in determining market trends. Thus, the lack of transparency hinders the appropriate decision to sell or buy and causes uncertainty about the appropriate value of the security price.
- Through the prohibition of *Gharar*, ignorance (lack of information about the qualities), and *Maysir* (uncertainty of the result), there is an imposition of transparency.
- The principle of profit and loss sharing enhances the transparency in an Islamic bank's activity by providing all basic information about the quality of projects and encouraging the Islamic Bank to ensure profitability of projects.

Therefore, transactions that are not related to the real economy and those of sale of securities without ownership, and transactions on intangible assets that conceal information and make it difficult to assess assets which affect the transparency of financial transaction, are forbidden in Islamic finance. In others words, it appears that among causes of the crisis are: changes in interest rates, debt selling, selling without ownership, speculation and gambling, the expansion of debt through the securitization of intangible assets[4], the high risk exposure of low-solvency loans such as poor quality mortgages, the lack of transparency of all important fi-

4 This is contrary to the correlation with the real economy in Islamic finance.

nancial and non-financial information of companies, lack of disclose in the balance sheets such as bankruptcy and the real characteristics of traded financial instruments.

Transparency standard in Islamic banking

From the Islamic viewpoint, financial accounting includes the right assignment and the disclosure of the financial position of the institution taking into account the distinction between *halal* and *haram*. Financial accounting should be committed to a system that protects rights and requires the necessary disclosure.

Islamic accounting is the process of providing appropriate information to interested parties to enable them to continue working under Islamic law (Hameed, 2009). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is working on the development of Islamic accounting and auditing standards for Islamic financial institutions. In fact, if Islamic banks were dealing with local accounting standards, it was difficult to compare their financial statements (Levy and Rezgui, 2013). AAOIFI was registered in Bahrain as a non-profit organization in 1991. It aims to unify the legal rules and accounting standards for the governance and the control of various Islamic financial institutions. In addition, the establishment of the Islamic Financial Services Board (IFSB) seeks to integrate Islamic finance into international finance (Elhamma, 2015).

AAOIFI Standards

AAOIFI has issued 95 standards; 54 Shari'a standards, 27 accounting standards, 5 auditing standards, 7 governance standards, and 2 codes of ethics. AAOIFI standards reflect concept and essence of Islamic finance transactions. Islamic accounting standards encompass the standard of presentation and the general disclosure in financial statements of Islamic banks and financial institutions (General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions), the standard of Murabaha and Murabaha for the purchase order (Murabaha and Murabaha to the Purchase Order), the Mudaraba financing standard, the Musharaka financing standard, the disclosure standard for the distribution of profits between the equity holders and the investment account holders right standard (Disclosure of Bases for Profit Allocation between Owners' Equity and Investment Account Holders), the standard of Salam and Parallel Salam, the standard of Ijara and Ijarah Muntahah Bittamleek, Zakat standard, Istisna'a and Parallel Istisna'a standard, the Standard of provisions and reserves, the standard general presentation and disclosure in the financial statements of the Islamic insurance companies, the standard disclosure of the basis of the determination and the distribution of the surplus in Islamic insurance companies (Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies), the standard of investment funds, the standard provisions and reserves in the Islamic insurance companies, the standard of transactions in foreign currencies (Foreign Currency Transactions and Foreign Operations), the standard of investments for Real Estates, the standard of Islamic financial services offered by Conventional financial institutions, the standard of Contributions in Islamic insurance companies, the standard of forward sales (Deferred Payment Sale), the disclosure standard for transfer of assets, the standard report on the sectors and the standard of unification of financial statements (Segment Reporting).

The importance of transparency and disclosure in Islamic banking

Transparency is an important legal principle. Islam requires transparency and full disclosure in the Quran and the Sunna. Transparency is a foundation in Islamic banking. It has been urged by Islamic law through the prohibition of *gharar, jahala* and *gambling*.

Islamic legislation highlights the documenting of financial transactions. In this context, the fair presentation and the disclosure of information preserves the rights, saves money and limits suspicion and disputes. AAOIFI takes into consideration the legal structure of the instruments, which are based on Shari'ah precepts (Ahmed et al, 2016).

AAOIFI accounting standards 1: *General presentation and disclosure*

There are many disclosures in this standard, for example:

- Adequate disclosure of important information in financial statements
- Disclosure of bank's basic information
- Disclosure of accounting measurement
- Disclosure of significant accounting policies
- Disclosure of profit or revenue which is not in conformity with the *Sharia*: disclose the amounts and the nature of gains made by the bank from the sources or ways prohibited by the law.
- Disclosing the concentration of the Bank's asset risk.

- Disclosing the concentration of sources of unrestricted investment accounts and other accounts.
- Disclosing the distribution of Bank's assets according to their maturity dates or the expected periods of their actual liquidation from the balance sheet.
- Disclosure contingent liabilities not recognized in the statement of financial position
- Disclosure of significant events subsequent to the date of statement of financial position
- Disclosing bank's assets allocated for specific purposes or used to secure the bank's obligations
- Disclosure of accounting changes: Disclosure of financial statements about the nature and effect of accounting changes.
- Disclosing the method used by the bank to distribute profits or losses between investment account holders and the bank as a *mudarib* or manager of investments

The importance of this Standard N°1 is to disclose several important matters, whether through financial statements, such as the disclosure of Bank's basic information, significant accounting policies, the concentration of risks of Bank's assets and the risks of assets and liabilities in foreign currencies. The disclosure also covers the method used by the Bank to distribute profit or loss between investment account holders, the transactions with related parties and disclosing each of financial statements.

These disclosures affect the ability to make investment decisions. This requires defining the rules, bases, principles and methods used in the preparation and publication of financial statements and the disclosure requirements in Islamic financial institutions.

AAOIFI accounting standards 5: *Disclosure of the basis for the distribution of profits between shareholders and owners of investment accounts*

This standard deals with the transparency of transactions between Banks, depositors and shareholders. The most important disclosures in this standard are (AAOIFI, 2007, p.252):

- The disclosure of unrestricted investment accounts and of restricted investment accounts and incentive income.

- For unrestricted investment accounts, the bank should disclose general principles followed by the Bank in the distribution of profits between the shareholders and the owners of unrestricted investment accounts, the expenses supported by unrestricted investment accounts, provisions and their beneficiaries when they are canceled, the general administrative expenses financed by investment accounts, the distribution of profits between shareholders and the owners of unrestricted investment accounts, the possibility of increasing the proportion of the bank's profits as *mudarib*, the possibility of involvement of unrestricted investment accounts with current accounts or any other funds accounts, the possibility of involving unrestricted investment accounts in banking revenues, which is, giving priority to the investment of the shareholders and investment accounts holders.
- For restricted investment accounts, the bank should adopt a disclosure of general principles in the distribution of profits between shareholders and holders of restricted investment accounts, the provision's support, the distribution of profits between the owners of equity holders, the shareholders and the holders of restricted investment accounts.
- In the case of incentive payments, the bank shall disclose: what is earned from unrestricted or restricted investment account profits and their relative importance in the case of agency relationship.
- Thanks to this standard n°5, justice is enforced by the knowledge of the basis of the distribution of profits and the disclosure of information that helps them to make decisions.

AAOIFI accounting standards 21: *Disclosure of the transfer of assets*

The most important disclosures in this standard are:

- The disclose of accounting policy adopted to transfer assets from unrestricted investment accounts to restricted investment accounts, and vice versa, to transfer assets from investment accounts (absolute or restricted) to owners' rights and vice versa, to convert assets from investment accounts and shareholders' funds to investment funds and or institutions with a special purpose, and vice versa.
- The disclosure of the reasons and bases that govern the transfer of assets between different investment accounts and the bases for valuation of transferred assets.

- The disclosure of promises by the contractual relationship between investment account holders and the property owners if any.
- The disclosure of the transfer of assets between the various investment accounts (including investment funds and owners' rights).
- The disclosure of all transfers made with related parties, indicating the nature of the relationship and the type of transactions performed.

This standard includes disclosures of the accounting policy related to the transfer of assets, the reasons and principles governing the transfer of assets, and the foundation on which assets are assessed when transferred. This standard preserves the rights of the different parties (shareholders, owners of various accounts), and avoids the bias (conflict of interest) by disclosing the nature of the relationship in the transfers with the parties involved. This contributes to a fair presentation of the financial position of financial institutions and helps users of financial statements to make their economic decisions.

We can conclude that there is a high degree of disclosure in standards imposed in all Islamic financial transactions. For example, besides the conventional disclosure, there is a disclosure on the basis of the distribution of revenues, the determination of selling prices, and the statement of the illegitimate part of bank activity.

We note similarities in many branches of Islamic accounting with traditional one such as financial accounting and cost accounting. Yet, Islamic accounting is characterized by its principles and methods in conformity with *Sharia*. Islamic accounting considers the debt as a fixed asset, whereas traditional accounting considers it variable as it depends on the repayment period of loans and the evolution of interest rate in the money market.

In the next section, we consider the case of Islamic banking financing offered by *murabaha* in order to discuss the transparency it conveys and to compare it to the conventional loan.

A sample of Murabaha

Murabaha is the most important form of financing offered by Islamic banks. We discuss the extent to which transparency is applied in the Murabaha contract for the purchase order.

We consider AAOIFI accounting standards 2 (Murabaha & Murabaha to the Purchase Order). In fact, since some financial transactions and practices are unique to Islamic banking and finance, AAOIFI standards are issued to apply to topics not covered by IFRS standards.

The qualitative and useful information on murabaha contracts should be disclosed and explained.

> 1/9/2: The Bank shall disclose the consideration of the promise made in the murabaha to the purchase orderer as obligatory or not in the notes to the financial position.[5]
>
> 2/9/2: The disclosure requirements of Financial Accounting Standard No. 1 regarding the presentation and general disclosure in the financial statements of banks and Islamic financial institutions must be observed.[6]

Islamic Bank disclosure focuses on many items: deferred profit, the guaranteed carrying value for non-performing murabaha receivables, the obligation of promise to purchase made in the murabaha to the purchase orderer, the amount of tangible collateral to murabaha contracts. Islamic bank shall disclose to the customer the price of the commodity and the details of expenses included in the price[7]. It is forbidden to consider unknown or future variables in the determination of the price or profit. The profit in the Murabaha contract is based on a known percentage of the cost and the profit is not linked to Libor or to time[8]. The bank can consider any expenses related to the commodity if it is agreed by the customer. However, if these expenses are not settled, the bank is only able to consider which is traditionally integrated such as transportation and storage expenses, documentary credit and insurance premiums[9]. The enforced transparency also appears since "If the firm obtains a discount from the seller on the commodity itself even after the contract, the customer will benefit from that discount by reducing the total price"[10].

Consequently, the terms of the Murabaha contract (knowledge of the first price, knowledge of the profit, knowledge of the costs and expenses, and knowledge of the commodity price) have been included. Among the condition of validity of Murabaha is to disclose the first price, the details of the expenses that will be included in the price and of profit. Thus, there is a focus on full transparency in the conclusi-

5 Financial Accounting Standard "Murabaha to the Purchase Orderer"
6 Financial Accounting Standard "Murabaha to the Purchase Orderer"
7 But, in practice, there is hiding of the actual cost of the commodity by many Islamic banks.
8 Standard sharia of murabaha 4/6
9 Standard sharia of murabaha 3/4
10 Standard sharia of murabaha 4/5

on of the Murabaha contract. Murabaha contract is characterized by a stable debt, through the determination of profit, and therefore the stability of the amount to be paid. Nevertheless, the sale at a variable future price leads to damage to one of the parties (lender or borrower) and causes *gharar*.

The traditional loan depends on the interest rate. Interest can be fixed or variable. Variable interest is most frequently used. Interest rate on loan changes during the term of the loan whenever the LIBOR changes. So, there is a lack of transparency throughout the loan duration due to the change in the interest rate without prior knowledge of the change, which affects the installments and the final amount to be paid. Even if the loan has fixed interest, in the case of delay in payment, an additional amount will be added as delay penalties. Consequently, there is no transparency in determining the final amount to be paid to the bank.

Lmahfoud (2015, p.16) compared murabaha and conventional loan and concluded that while in loan, interest paid is linked to the amount of loan and changes in relation to the passage of time; in murabaha, the profit margin is determined by the agreement based on the cost price of the financed equipment.

Conclusion

In 2008, the global economy experienced a financial crisis caused by the *subprime* mortgage problem in the United States. One of the main reasons behind this crisis was the lack of information transparency. As Islamic banks were almost unaffected by this crisis, this study focused on the criteria of transparency and disclosure in Islamic banking standards and compares them to the conventional ones. The specific research objective is to examine whether there are differences in financial transparency standards between Islamic and conventional financing.

By examining the traditional accounting standards of transparency, namely IAS 1, IAS 24 (Related Party Disclosures), and IFRS 7, we highlight that although the conventional banking strives to achieve transparency, there is a lack of optimal transparency in conventional banking products. This is due to lack of determining the rate of change of interest and premiums and the amount for loans with variable interest, securitization and the sale of debt. These problems led to a low level of financial transparency, which in return raised the risk of default and bankruptcy in *Subprimes* crisis.

Nevertheless, the principles of Islamic finance, such as the prohibition of *riba* and *gharar* as well as its link to the real economy, emphasize transparency in Islamic banking transactions. Financial transparency is one of the fundamentals of Islamic banking. It is also a condition of the contract's validity. AAOIFI has issued 95 standards which reflect concept and essence of Islamic finance transactions.

Focusing on many AAOIFI accounting standards, we conclude that a high degree of disclosure in standards is required in Islamic banking. Besides the conventional disclosure, there is a disclosure on the basis of the distribution of revenues, the determination of selling prices, and the statement of the illegitimate part of bank activity.

For example, the Standard N°1 permits to disclose several important matters through financial statements, such as the disclosure of Bank's basic information, significant accounting policies, concentration of risk of Bank's assets, and the risk of assets and liabilities in foreign currencies. Further, thanks to Standard n°5, transparency is enforced by the knowledge of the criterion for the distribution of profits between investment account holders whether unrestricted or restricted.

We highlighted that the validity of the Murabaha contract for the purchase order is conditioned by the disclosure of the first price and the details of expenses taken into consideration in the price and disclosure of profit. Islamic accounting considers the debt as a fixed asset (stable debt regarding profit and the amount to be paid), whereas traditional accounting considers it variable as it depends on the repayment period of loans and the evolution of interest rate in the money market. We conclude that disclosure is enforced more in Islamic accounting than in conventional one.

Islamic banks are urged to adhere to the AAOIFI standards to achieve financial transparency. Besides, the macroeconomic legal system of the countries in which these Islamic banks operate must ensure that banks comply with them. The items of financial transparency should be revised by AAOIFI as far as Islamic banking products develop. The scope of this research was to compare the extent to which transparency is applied in conventional leasing and Ijara in Islamic finance. A study of the impact of financial transparency on Islamic banking performance can also be carried out.

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