Talha YANMAZ

M.A. Thesis in Economics

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A KIND OF ISLAMIC FINANCIAL INSTRUMENT: SUKUK AND APPLICATIONS IN THE WORLD

Thesis submitted to the

Institute of Social Sciences

In partial fulfillment of the requirements

for degree of

Master of Arts

in

Economics

by

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DEDICATION

I would like to seize the opportunity to express my gratitude to everyone who has accompanied me through the long years at university and assisted in the completion of this thesis. First, I have to thank my supervisor, Prof. Dr. Ismail OZSOY, for his expertise, encouragement, support and stimulating suggestions. I am thankful to Assistan Professor Ahmet CALİSKAN and Abdülkadir CIVAN for their theoretical contribution.

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APPROVAL PAGE

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I certify that this thesis satisfies all the requirements as a thesis for the degree of Master of Arts.

Assoc. Prof. Mehmet ORHAN
Head of Department

This is to certify that I have read this thesis and that in my opinion it is fully adequate, in scope and quality, as a thesis for the degree of Master of Arts.

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It is approved that this thesis has been written in compliance with the formatting rules laid down by the Graduate Institute of Social Sciences.

Assoc. Prof. Mehmet KARAKUYU
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AUTHOR DECLARATIONS

1. The material included in this thesis has not been submitted wholly or in part for any academic award or qualification other than that for which it is now submitted.

2. The program of advanced study of which this thesis is part has consisted of:

i) Research Methods course during the undergraduate study

ii) Examination of several thesis guides of particular universities both in Turkey and abroad as well as a professional book on this subject.

Talha YANMAZ

June, 2011

ABSTRACT

Talha YANMAZ **June 2011**

A KIND OF ISLAMIC FINANCIAL INSTRUMENT: SUKUK AND APPLICATIONS IN THE WORLD

Principal feature of Islamic financial tool is being interest-free because of prohibition of interest in Islam. Sukuk structure is mainly about liquidation of assets by issuing sukuk. Sukuk brings its holder periodical income. Especially after deep economic crisis in 2008 it is perceived that sukuk is becoming the most popular financial tool. In this study firstly sukuk and its structure will be explained secondly a new sukuk model for Turkey will be recommended. Interest-free implementation is the main feature of sukuk. Interest is debated over years and seems to be continued. The interest rate based financial practices have been carried out since the beginning of the history. Interest based economies carries risk because of interest, last deep economic crisis showed this fact. Sukuk is an alternative way for funding companies or governments which applies special mechanisms and backed by real economic value. Sukuk implementation started to use in Malaysia and other Islamic nations take this financial tool quickly. Today sukuk is used not only in Islamic countries but also developed western economies uses sukuk for financing. We could say that the most prevalent type of sukuk is Ijarah Sukuk. Turkey newly introduced in sukuk. Turkey is a unique nation who has Muslim population and secular democracy. We suggest new sukuk implementation in Turkey because like other economies Turkish economy has unique conditions. Sukuk also includes some financial risks our new model is proposed to explain these risks and minimize them. Our study is the first study which recommends new sukuk model.

Keywords: Sukuk, Islamic Finance, Bond, Interest, Participation Banking

KISA ÖZET

Talha YANMAZ **Haziran 2011**

ÇAĞDAŞ FİNANSAL ARAÇLARDAN SUKUK ve DÜNYADAKİ UYGULAMALARI

Faizin yasak olduğu İslam dünyasında finansal araçların başlıca özelliği faizsiz çalışma esasına dayanmasıdır. Bu kapsamda çıkartılan İslami finansman sertifikası sukuk esas olarak varlık finansmanı için çıkarılmakta olup, elde edilen fonla alınan varlık/yapılan yatırımdan elde edilecek gelirin Sukuk sahibine belli dönemlerde ödenmesi esasına dayanmaktadır. Sukuk 2008 yılındaki ağır ekonomik bunalımdan sonra popülaritesi en çok artan finansal araç olarak karşımıza çıkmaktadır. Çalışmamızda alternatif finansman aracı olan sukuk ele alınacak ardından Türkiye'ye özgü bir sukuk modeli önerilecektir. Sukuk'un en önemli özelliği faizsiz bir finansman aracı olmasıdır. Faiz yıllardır tartışılmaktadır ve görünen o ki tartışılmaya devam edilecektir. Faiz uygulamaları tarihin ilk yıllarından itibaren hemen hemen her toplumda görülmüştür. Faiz eksenli ekonomiler her zaman risk taşır, son ekonomik kriz bu gerçeği ortaya koymuştur. Sukuk; devletler ve şirketler tarafından kullanılan özel şekiller içeren ve gerçek bir ekonomik değer tarafından desteklenen bir finansal araçtır. Sukuk uygulamaları Malezya'da ortaya çıkmış ve kısa sürede diğer İslami ülkelere yayılmıştır. Sukuk bugün sadece İslami ülkeler tarafından değil aynı zamanda gelişmiş batı ekonomileri tarafından da kullanılan bir finansal araçtır. En yaygın olarak kullanılan sukuk çeşidinin icara sukuk olduğu görülmektedir. Türkiye ekonomisi sukuk ile henüz yeni tanışmıştır. Türkiye Müslüman halkı ve laik demokrasiye sahip kendine özgü koşulları bulunan bir ülkedir. Çalışmamızda Türkiye'de sukuk uygulamaları için yeni bir model önerilmiştir çünkü her ekonominin olduğu gibi Türkiye ekonomisinin de kendine özgü koşulları bulunmaktadır. Sukuk bununla birlikte diğer finansal araçlarda olduğu gibi bazı riskler içermektedir, yeni model çerçevesinde bu riskler minimize edilmeye çalışılmıştır. Çalışmamız Sukuk hakkında yeni model öneren ilk çalışma olma özelliğindedir.

Anahtar Kelimeler: Sukuk, İslami Finans, Bono, Faiz, Katılım Bankacılığı

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INTRODUCTION

In today's economic conditions economic crises occur frequently and these economic crises damage economy through the world. In 2008 economic crisis which originated from United States damaged world economy very much. Governments organize macroeconomic programs. –which means printing Money- decreased damage of economic crisis but it was not enough. Causes of crisis still being debated but the main reason were 'bubble economy'. The FED President Alan Greenspan pointed out this by saying''*The notion of bubble bursting and the whole price level coming down seems to me as far as a national nationwide phenomenon, is really quite unlikely''*[1]Bubble economy, refers to economic values which are not backed by real economic asset. After 2008 crisis Islamic financial institutions like sukuk had sparked by economic actors. Some giant banks like HSBC grew its Islamic finance department. (see in HSBC Official website www.hsbc.com) Vatican also pays attention to interest and sukuk. Vatican-centre of catholic Christians- declared main reason of economic slumps is interest and sukuk may be an appropriate tool for finance[2]. Sukuk came into prominence in economic environment and there is no enough study about sukuk especially in Turkey. Sukuk has some types and different implementation methods. We will explain interest before sukuk to be more comprehensive. In this study we will explain interest, interest free banking, financial bonds and sukuk. At the end of the study we will recommend new sukuk model for Turkey.

Interest has been used by human being since old decades. Types of interest changed but interest was existed. Interest arises from need of debt. Some people have extra money and some people need money to do business or consume. Capitalism defends interest by saying' interest is value of giving up usage of capital if there were no extra amount no one will lend money to others'[3] this defending may be correct in today's capitalist world. Today people are so individualistic and there is no trust between people then interest is accepted as *de facto* correct. On the other hand

[1] http://www.fairloanrate.com/2008/12/02/the-reasons-behind-global-economic-crisis/
[2] http://www.tkbb.org.tr/index.php?option=com_content&task=view&id=2922&Itemid=846
[3] Keynes J. M. (1936) General theory of Employment,Interest and Money, p. 10

interest damages economic environment by setting fee of extra amount before doing business. If interest rate is over than profit lender has unfairness if contrary borrower has unfairness so in dynamic economy interest is always origin of unfairness. Secondly as Keynes explains interest rate effects investments[4], if interest rate is high people try to get interest earning instead of investment return because interest has no risk according to lender he will get return certainly. Interest is forbidden in monotheistic religions but this sight is theologians' mission.

In first chapter we will explain kinds of income such as interest, profit and rent. Sukuk which is an alternative way to interest based on bonds arisen from rent so an important sub-chapter of first session is difference between rent, profit and interest. In second chapter interest free banking is explained. Interest-free Banking applications and differences between private banks and Interest-free banks tried to be defined. In third chapter financial bonds are explained to define difference between bonds and sukuk more explicitly. Types of financial bonds discriminated according to its usage or return type.

In the last chapter we explained sukuk. Sukuk is an alternative way to finance companies or governments instead of bonds. Sukuk is not based on interest; it is interest free financing tool. Especially after deep economic crisis which occurred in 2008, popularity of sukuk increased because, main reason of economic crisis was economic bubble. Financial tools which is not backed by real economic value carries more risk than sukuk so also western economies started to use sukuk. Turkey has just amended its sukuk law[5] and only one sukuk issuance has made so sukuk market has not grew enough in Turkey but it is estimated that with gulf capital sukuk market will grow in Turkey. In this study there is a new model recommendation for sukuk application in Turkey. Aim of new model is minimizing sukuk risk and designing appropriate model for Turkey. Turkey should take lessons from its history Contrary of its popularity there is not enough academic study about sukuk, aim of this study is to contribute to sukuk literature.

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[4] Keynes J. M. (1936) General theory of Employment,Interest and Money, p. 11

[5] http://www.spk.gov.tr/apps/teblig/displayteblig.aspx?id=393&ct=f&action=displayfile

LITERATURE REVİEW

Literature about sukuk is very restricted because sukuk is new growing financial tool. There are some reports of IMF and World Bank about sukuk structure and sukuk trends in the world. Studies about sukuk focused on usually Islamic countries. Study about sukuk could be separated two sub-headline Sukuk studies and Islamic finance studies. Islamic finance studies indirectly tell about sukuk. Nathif J. Adam and Abdukader Thomas wrote may be the most wide sukuk book named' Islamic Bonds: Your guide to Issuing, Structuring and investing in sukuk'. In this book sukuk structures and how return of sukuk could be maximized are studied. Also Why Islamic finance will be more popular in the future is explained. Euromoney published a book about sukuk in April 2011 which name is 'Global Growth, Opportunities and Challenges in the Sukuk Market'. The another important study about sukuk is written by Mohmoud A. El-Gamal from Rice University named' Leasing Securitizaton and Sukuk '.This book explain differences between sukuk and leasing giving by advantages and disadvantages of them. 'Sukuk and Islamic Capital Markets' edited by Rahal Ali is another new book about sukuk published in 2010. This books analysis market trends and key Shariah and legal structures about sukuk. These books are published very new the oldest book is published in 2009. Ali Arsalan Tariq's study about sukuk risk named 'Managing Financial Risks of Sukuk Structures' is very useful study about sukuk because other studies focus on what is sukuk but this Tariq's study focused on risks of sukuk. These studies show us that sukuk is very new issue for scholar and need to be studied more. Studies about sukuk explain only applicated sukuk structure and market trend there is no study which recommends new sukuk model. There is no Turkish book about sukuk because sukuk is very new concept for Turkey and only one sukuk issuance has made.

There are a lot of books and articles about interest free banking because interest free banking is not new phenomenon. The widest study about Islamic banking is 'Handbook of Islamic Banking' edited by M. Kabir Hassan and Mervyn K. Lewis. This book explains all sides of Islamic banking. Old studies about Islamic finance written by muslim academicians but especially after world economic crisis western scholars also interested into Islamic finance.

In Turkey studies on sukuk are not sufficient, it is written in Islamic banking studies. Hovewer Interest is the most debated issue in Turkey. Some scholars like Suleyman Uludag defends in his book ‘Islam’da Faiz Meselesine Yeni Bir Bakış (A new outlook on the issue of interest in Islam)’that interest and riba are different concept so today’s interest is not forbidden in Islam. He claims that Islamic banking is cheating Shariah rules. Ismail Ozsoy has a study about interest named ‘Faiz ve Problemleri (Interest and Its Problems) ’. He claims that every extra amount which has not any reciprocity is interest so interest and riba are same things. Islamic Banking is not forbidden in Islam because Islamic Banking implementations do not include interest. Implementation is important and some special implementations differentiate interest concept.

CHAPTER1

KINDS OF INCOME

In this chapter we will explain kinds of income called; interest, profit, rent. Because of Sukuk refuses interest and based on rent income, firstly we should define interest, profit and rent. Economist tried to explain these concepts so that define which motives shape the whole economy. We will compare interest, profit and income. It is important to understand these concepts correctly because these concepts are the basis of disputes around interest. Sukuk is alternative financial tool to interest because it is based on rent. Some economists say that interest is equal to profit or rent, consequence of both of them is the same only interest is fee of money. Profit is income gained from real economic utility production. First we will try to explain what is interest? Secondly we will explain interest in religions. In the conclusion we will explain difference between interest, rent and profit.

1.1 Interest

Interest is a one of the key concept of modern capitalist world. A debate over interest continues and seems to be continued as long as human being alive. Interest is an old being concept which comes from history of the world. There are a lot of theories about interest some of them are defending interest and some of them offending.

1.1.1 Definition of Interest

First of all we should define interest. According to dictionary interest is 'The fee charged by a lender to a borrower for the use of borrowed money usually expressed as an annual percentage'.[6] There are some other interest definitions; basically 'interest is value of money. Founder of economics Adam Smith see interest as ''giving money to lender from profit of doing business'' English economist David

[6] www.investorwords.com (15.03.2011)

Ricardo said that "If there is huge profit, interest can be given to have that capital' Classical economists claims that interest rates encourage people to save Money but Keynes criticized that view.[7]

Interest is of two kinds.[8] First, interest of loan (riba al-dain in Arabic), one that appears in loans as a percentage or any fixed payment added to the principle, is the most widespread, and the most debated, kind of interest known by all. Lending money, say €100, at a certain interest rate, say 5%, is the example. Second is interest of exchange (riba al-bai' in Arabic), one that appears in exchanges. The second one -interest of exchange- is also divided into two kinds; one is called interest of surplus (riba al-fadl in Arabic) that appears as a quantitative surplus in one of the exchanged goods of the same kind -as in the case when two measures of corn is exchanged for three measures of corn, even if it is due to the difference of quality. And the other is called interest of delay or deferral (riba al-nasia in Arabic) that appears in exchanges as a quantitative or potential surplus (value differentiation) when the delivery of one of the goods exchanged is delayed, as in the case when a ton of iron is sold for the same amount of iron on a deferral basis; let alone for a larger amount of delayed iron.[9]

According to john Maynard Keynes ' Interest, being the price paid for the use of capital in any market, tends towards an equilibrium level such that the aggregate demand for capital in that market.'[10] The famous economist Pigou tries to explain interest as 'The nature of the service of "waiting" has been much misunderstood. Sometimes it has been supposed to consist in the provision of money, sometimes in the provision of time, and, on both suppositions, it has been argued that no contribution whatever is made by it to the dividend. Neither supposition is correct. '"Waiting" simply means postponing consumption which a person has power to enjoy immediately, thus allowing resources, which might have been destroyed, to assume the form of production instruments.[11] The most accepted theory of interest in

[7] Qureşi I. (1972) Interest Approach and Islam. Istanbul: Irfan Publications, p. 43
[8] Özsoy İ.(1993) . Faiz ve Problemleri. İzmir: Nil Yayınları
[9] Ozsoy I.(2010). ' Islamic Banking: Conceptual Fundamentals and Basic Features' Economical Herald Quarterly
[10] Keynes J. M. (1936). General theory of Employment,Interest and Money ,p. 119
[11] Pigou A. C.(1920). Economics of Welfare 3rd edition, p. 162

capitalist world made by Bohm-Bawerk, according to Bawerk interest is' value of time is important for interest, who lend money to borrower sacrifices consumption ability by that money so interest is value of time'. This theory called 'Time preference theory of interest.' Theory is known as 'Austrian hypothesis**'** Theory is centered on time preference**.** [12]

There are a lot of interest theories but most of them are derivatives of these theories and no need to replicate here. Interest importance increased after capitalism process. Before capitalism surplus capital, goods and services were limited but capitalism increased surplus of capital, goods and services so need of lending and borrowing capital become more prevalent.

Some philosophers criticized interest because of money is transferred from poor to rich but after capitalism become more powerful, banking sector start to having deposits from poor also so money started to transferred from rich to poor. Criticisms' of 'interest is destroys fairness of income between poor and rich' became invalid.

The other criticism of interest is 'lender is not working and getting money by free but today bank employees are working more than other sectors most of them going their home after than normal working hours.

According to Mercantilist ideology (1500-1700), 'interest is rent of capital.' Mercantilists' see interest same as land rent or real estate rent.[13] On the other hand Physiocrats who see trade is not good for economy, land is the only effective production method so capital could not be given unless that capital's interest is equal to rent value.[14]

'Productivity of capital theory' first acclaimed by J. B. Say, and theory developed by Maitland Lauderdale (1759-1839). Theory is based on productivity is natural result of capital. Labor can be substituted by capital so substitution proves

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[12] Böhm Bawerk E (1891) The Positive Theory of Capital. www.econlib.org e-book.
[13] Schumpeter, J.(1954). Economic Doctrine and Method. London: George Allen and Unwin Ltd, 28; Qureşî, p. 40; Uludağ S., p. 247.
[14] Özsoy İ.(1993) . Faiz ve Problemleri. İzmir: Nil Yayınları, p. 31

that capital has also productivity. Productivity deserves rent, wage or in capital interest. In conclusion interest is logical because there is increase of productivity.[15]

1.1.2 Historical Progress of Interest

There is not sufficient information about interest in ancient times. We know that interest exist in ancient times. Money is not so prevalent and did not used for trade. Trade was made by exchange of goods. It is called barter economy. Interest basically paying debt with surplus so if anybody for example paying his debt over then his debt it is called interest it's not important debt is money or wheat or fish.

In ancient times interest is controlled by religious men. Interest rate is determined by religious men. It shows that religious men deal with interest for ancient times.[16]

There are some documents about interest rates in ancient Sumer and Babylon. According to that documents interest rate is 1/3 for nurture and 1/5 for money debts.[17]

In ancient Greece people and temples used to have interest earnings so they became so rich. Sometimes interest rate increases so some debtors could not pay it and he lost his freedom-became slavery-.[18] In India interest is forbidden to higher cast. Interest is used by lower cast.[19]

There were heavy tax burden in Rome so public need to take money from knights with interest. [20] Interest was forbidden in BC 342 by Lexgenucia nevertheless interest continued because of economic needs. At the end of Rome Republic interest rate was limited. Roman Empire was the first nation who tried to forbid interest so that protecting poor people.

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[15] Ergin Feridun(1981) , Para ve Faiz Teorileri, İstanbul Üniversitesi Yayınları, p. 178-179.
[16]Zeme H. and Faruk M.(1968). History of interest and Islam. Istanbul:Sinan Publications
[17] Türk Ansiklopedisi (1985). MEB Yayınları, Interest Issue, p. 86
[18] Türk Ansiklopedisi (1985). MEB Yayınları, Interest Issue, p. 87
[19] Uludağ S.(2010). İslam'da Faiz Meselesine Yeni Bir Bakış, Istanbul: Dergah Yayınları, p. 283
[20] Türk Ansiklopedisi (1985). MEB Yayınları, Interest Issue p. 87

Philosophers also thought about interest. Most of philosopher accepted forbidden of interest and they tried to explain prohibition logically. Aristoteles who influenced Islamic thoughts is against of interest. According to Aristoteles capital is not productive tool itself. Money does not increase itself without labor. Money's value is fixed, its value cannot be increased even you wait 100 years. He said ' There are two sorts of wealth-getting, as I have said; one is a part of household management, the other is retail trade: the former necessary and honorable, while that which consists in exchange is justly censured; for it is unnatural, and a mode by which men gain from one another. The most hated sort, and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural object of it. For money was intended to be used in exchange, but not to increase at interest. And this term interest, which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefore of any modes of getting wealth this is the most unnatural.' At his famous book Politics. [21]

Platon who is Aristotle's teacher also offended interest. His tried to explain interest by marriage. He said in his book 'In marrying and giving in marriage, no one shall give or receive any dowry at all; and no one shall deposit money with another whom he does not trust as a friend, nor shall he lend money upon interest; and the borrower should be under no obligation to repay either capital or interest.'[22]

1.1.3 Interest in Judaism

Criticism of interest in Judaism has its roots in several Biblical passages in which the taking of interest is either forbidden, discouraged or scorned. The Hebrew word for interest is neshekh, literally meaning "a bite" and is believed to refer to the exaction of interest from the point of view of the debtor. In the associated Exodus and Leviticus texts, the word almost certainly applies only to lending to the poor and destitute, while in Deuteronomy, the prohibition is extended to include all money lending, excluding only business dealings with foreigners. In the levitical text, the words tarbit or marbit are also used to refer to the recovery of interest by the creditor.

[21] http://classics.mit.edu/Aristotle/politics.1.one.html (03.02.2011)
[22] http://classics.mit.edu/Plato/laws.5.v.html (05.02.2011)

In addition to these biblical roots are various Talmudic extensions of the prohibitions of interest, known as ‘avak ribbit’ literally "the dust of interest" which applies, for example, to certain types of sales, rent and work contracts. This is distinguished from rubbit kezuzah, interest proper in an amount or at a rate agreed upon between lender and borrower. The difference in law is that the latter, if it has been paid by the borrower to the lender, is recoverable from the lender, while the former, once paid, is not recoverable, although a contract tainted by the dust of interest will not be enforced. Despite the prohibition on taking interest, there is considerable evidence to suggest that this rule was not widely observed in biblical times. In addition to several references in the Old Testament to creditors being exacting and implacable in their extraction of interest, from the Elephantine papyri it appears that among the Jews in Egypt in the fifth century B.C. it was a matter of course that interest would be charged on loans .This charitable nature of the prohibition on interest suggests that its violation was not regarded as a criminal offense with penal sanctions attached, but rather as a moral transgression. The phenomenon of evasion can also be partly explained by changing economic conditions, beginning in the amoraic period in Babylonia when interest prohibition was held to no longer be compatible with the economic needs of the community. In time, a standard form of legalization of interest was established, known as ‘hetter iskah’ meaning the permission to form a partnership, which has become so accepted that nowadays all interest transactions are freely carried out in accordance with Jewish law, by simply adding to the note or contract concerned the words ‘al-pi hetter iskah’.[23]

The next step is to substantiate the time-based focus of the interest prohibition. The key source is Rav Nachman[24], Who states that the general rule of interest is that any reward for waiting for one’s money is forbidden. The classic biblical commentaries of Rash, Ritva and Divrei Sofrim confirm the importance of Rav Nachman’s words. They point out that his rule is an embracing one which applies to both biblically and talmudically proscribed interest. Any gain received simply for waiting for one’s money or one’s goods constitutes interest. ‘Because of

[23] http://www.che.ac.uk/publications/usury.htm, Wayne A.M. Visser and Alastair McIntosh
[24] Talmud, Tractate Bava Metzia: p. 63

the delay of the money the borrower gives his reward' says David Ben Israel Ha Levi Segal in the commentary known as Turei Zahav. Clearly the time aspect is singled out. The passage does not, at least explicitly, address charging a risk premium or compensation for transaction costs. Indeed lending is positively discouraged where the loan is unsafe. A gift is better: 'it is better not to lend without taking a pledge, than to lend and to be compelled to keep dunning the debtor for repayment'[25] . There is no encouragement to lend, even to a person who could repay by installments. In such cases, a gift, or business partnership, may be more appropriate. The beneficiary would, in this way, be protected from the shame of defaulting on a loan.[26]

Lister tried to explain Judaic reasons of prohibition of interest bu on the other hand it could be seen that he also tries to explain why prohibition of interest is not applicable in capitalized, globalised world. After listing reasons of prohibition he wrote interest theories, time preference and risk. He implies that prohibition is fact ancient times of Judaism but now prohibition is not logical. It can be understood because capitalism is based on interest and Jewish people are the most beneficiary of capitalism.

In the Middle Ages it is accepted that the main job of Jewish people is lending money but some academicians opposes it. A work on Jewish people in ottoman Empire by Haim Gerber-Hebrew University- states that Jewish people lends money but not so much they have another jobs to do.

''It is generally assumed that during the Middle Ages and afterwards Jews everywhere was engaged in money-lending as their main occupation. However, this does not appear to have been the case in the Ottoman Empire. It would seem that in this state money-lending was of far lesser importance than elsewhere. The false impression may have been due, at least in part, to a reliance on Hebrew sources

[25] Chafetz Chaim (1967). p. 47

[26] Lister R. J. (2006). The Composition of Interest: Judaic Prohibition. Accounting,Business and Financial History Magazine 16, 121-126

alone. These in themselves are extremely important, but for such a subject they reveal only one side of the coin.’’[27]

On the other hand Gerbert accepted Jewish people are the main factor of increasing interest applications in economic activities. With feeling guilty, He says ’It is thus evident that the unique pattern of Jewish money-lending in Jerusalem was the outcome of two factors: the pressure of the Christian monasteries for loans on the one hand, and the fact that the Jewish community of Jerusalem lacked a normal economic structure on the other. These two factors inevitably created a situation in which money-lending became the Jews' main sustenance. But this situation was far from representative of other Jewish communities in the Empire.’

Jewish rabbis claimed that giving money to foreigners with interest is not forbidden. It is thought that interest is harmful to community so if harmful habits are applied to foreigners they will be weak. Weakness of foreigners is beneficial to Jewish. Such as Professional Jewish money-lending specifically to non-Jews is apparent in an extremely revealing document from 18th-century Rhodes. The problem set forth in this document is the following: some Jews had lent money on interest to a high Turkish official who for a long time failed to repay it. The Jews, having lost all hope of repayment, demanded that this sum be deducted from their tax assessment. The Rabbi denied their request, and explained that to grant it would cause grave harm to the com-munity, for "most of our living nowadays comes from lending money to non-Jews and here in Rhodes it is customary to take into account for tax assessment all credits and loans, and most of what is written down in the tax assessment register is of this type. [28]Different applications to other nations could be seen in Islam’s two sects being called ’Dar-ul Harp’ (being in war). But after economic conditions changed Jewish people did not obeyed their religion and started to use interest in their economic activities. The word money lender is known also ‘Jewish’ in English because of most money lenders are Jewish. Huge banks are owned by Jewish people now. We may see that interest is forbidden in most religions

[27] Haim G. (1981).Jews and Money Lending in Ottoman Empire. Jewish Quarterly 72, p. 100-118
[28] Haim G. (1981).Jews and Money Lending in Ottoman Empire. Jewish Quarterly 72, p. 108

but people tried to overcome religious rules and may and some extra way to apply interest in economic activities.

1.1.4 Interest in Christianity

There is a few ordering rules in bible so Christians accepted Jewish rules for interest. Also in Christianity interest is forbidden. Giving money to poor people is encouraged and interest is forbidden. There are three stages for interest in Christianity first churches, monks were fiercely against interest and tried to prevent community from interest. Second, interest prohibition became more strict money lender were being punished. Saint Thomas, Molina and Scott were the main thinkers who offended interest. Third church accepted interest as an economic activity and abolished prohibitions because of events and new economic activities. After abolishment most of Christians started to take and give interest as a normal way.

There are five situations that interest can be given or taken these are;

- ‘Damnun Emergence’ (Suffer a Loss): If lender had gotten a loss because of lending that money, he or she can put an interest to money. But interest cannot be over of loss.
- ‘Lucrum Cessans’ (To miss a Profit Opportunity): Lender could miss a profit opportunity because of lending that money. For example a trader lend money to anyone and that time trading god is cheap because he lend money he cannot buy good, if good got more expensive he will miss profit opportunity.
- Risk: If lender gets a risk because of lending money to him he can put interest to that amount. We may say that every lending activity contains a risk so this situation can be used for all lending activities. This makes interest forbidden unusable.
- Compensation: If lender and borrower have agreement about interest to be put, Christianity allows this kind of interest.

- Traditional Laws: Interest could be come from traditions. In some communities interest comes from tradition in this case Christianity allows interest.[29]

We can see that interest is forbidden in Christianity but this prohibition is not applicable. One may put interest in base of above exception. Normally people defend interest in case of above situations. Church tried to prohibit interest but after capitalism church’s power decreased and economic environment changed so nobody obey interest prohibition.

Despite its Judaic roots, the critique of interest was most ferverently taken up as a cause by the institutions of the Christian Church where the debate prevailed with great intensity for well over a thousand years. The Old Testament decrees were resurrected and a New Testament reference to usury added to fuel the case. Building on the authority of these texts, the Roman Catholic Church had by the fourth century AD prohibited the taking of interest by the clergy; a rule which they extended in the fifth century to the laity. In the eighth century under Charlemagne, they pressed further and declared usury to be a general criminal offence. This anti-usury movement continued to gain momentum during the early Middle Ages and perhaps reached its zenith in 1311 when Pope Clement V made the ban on usury absolute and declared all secular legislation in its favor, null and void. Increasingly thereafter, and despite numerous subsequent prohibitions by Popes and civil legislators, loopholes in the law and contradictions in the Church's arguments were found and along with the growing tide of commercialization, the pro-interest counter-movement began to grow.

The rise of Protestantism and its pro-capitalism influence is also associated with this change, but it should be noted that both Luther and Calvin expressed some reservations about the practice of interest despite their belief that it could not be universally condemned. Calvin, for instance, enumerated seven crucial instances in which interest remained "sinful", but these have been generally ignored and his

[29] Uludağ S.(2010). İslam’da Faiz Meselesine Yeni Bir Bakış, Istanbul: Dergâh Yayınları, p. 294-295

stance taken as a wholesale sanctioning of interest. As a result of all these influences, sometime around 1620, according to theologian Ruston, "interest passed from being an offence against public morality which a Christian government was expected to suppress to being a matter of private conscience (and) a new generation of Christian moralists redefined usury as excessive interest". This position has remained pervasive through to present-day thinking in the Church, as the indicative views of the Church of Scotland suggest when it declares in its study report on the ethics of investment and banking: "We accept that the practice of charging interest for business and personal loans is not, in itself, incompatible with Christian ethics. What is more difficult to determine is whether the interest rate charged is fair or excessive."Similarly, it is illustrative that, in contrast to the clear moral injunction against usury still expressed by the Church in Pope Leo XIII's 1891 Rerum Novarum as "voracious usury ... an evil condemned frequently by the Church but nevertheless still practiced in deceptive ways by avaricious men", Pope John Paul II's 1989 Sollicitude Rei Socialis lacks any explicit mention of usury except the vaguest implication by way of acknowledging the Third World Debt crisis.[30]

Martin Luther Founder of Protestantism prohibited all kind of interest but only interest which used for trade is allowed. It is very strange that America whose people are Protestants is now the center of capitalism and interest.[31]

Calvin opposed laziness and luxury, but stimulated working for life. Calvin did not agree on interest with Aristotle. According to Calvin interest is not prohibited in production process. Turgot said that interest rate should be set up on free market.

Thomas Culpeper said ‘If there is %10 interest rate everybody will not do any business lower than %10 profit so high interest rate destruct investment such as agriculture, foresting, exploring oceans…’[32]

Now in western world nobody argues about interest is prohibited or not. Interest rate is debated on which interest rate is the optimum for production and

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[30] http://www.che.ac.uk/publications/usury.htm, Wayne A.M. Visser and Alastair McIntosh
[31] Uludağ S.(2010). İslam’da Faiz Meselesine Yeni Bir Bakış, Istanbul: Dergah Yayınları, p. 298
[32] Thomas Culpeper (1673). Tracts Concerning Banking and Usury.

community. On the contrary of Christian bible, interest is accepted as valid and useful for economic environment.

Even if Christianity has different holy book, Christianity has hardly effected by Judaic applications. Because most of Christians think that Christianity is continue of Judaism. In the Middle Ages Christians were accusing Jewish people for living only this world and calculating perfectly was the sign of being Jewish.

1.1.5 Interest in Islam

Shariah is the body of Islamic religious law that determines the legal framework within which the public and private lives of Muslims are regulated. A large portion of Shariah is dedicated to how the economy of Muslim societies should operate. Islam is one of the only major religions that offer guidance on this subject. Islam not only defines the world another but also how Muslims should live. Islam is the only religion that arranges society of its members. Part of the body of law regarding the economy forms the foundation of what has become the modern Islamic finance industry. The root of the Islamic financial system is the prohibition of riba in society. Riba-an Arabic word- is often defined as paying or charging usury or interest, though its meaning is broader.[33] It will be called interest, riba and usury as same meaning. Some people tried to differentiate interest and riba, they claim riba is forbidden but interest is not prohibited it is a using concepts to mislead people, as it will be explained riba, usury and interest are the same concept.

The root of the Arabic word riba means to increase, to grow, to exceed, to exact more than was due, or to practice usury. There are two types of riba: riba al-nasiah and riba al-fadl. Riba Al-Nasiah refers to fixing in advance a required return on a loan as reward for waiting. This action is prohibited by the Shariah, Islamic law, whether the return is a fixed or variable percentage of the principal or an absolute amount. Riba al-nasiah can also be translated as paying or charging usury or interest in English. Riba al-nasiah is commonly what is referred to when discussing riba in Islamic finance.

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[33] Mavrakis N.(2009). Islamic Finance; a Vehicle for Development. University of Texas e-book, p. 3

Riba al-fadl refers to the trading of commodities that are the same genus but of different qualities, rather than for cash. These injunctions are reported by Abu Said al-Khudari as: "Sell not gold for gold except in equal quantity, nor sell anything for the same thing in lesser quantity ... nor sell anything present for that which is absent’’[34] Riba al-fadl is prohibited because there may be differences in the quality between the two goods, which, if traded, could lead to unjust enrichment by one party. Examples of this type of transaction are given when discussing the sources of Shariah below.[35]

1.1.5.1 Interest in Quran (Holy Book)

The Quran-holy book of Islam- refers to riba several times, one of them is; ’’ What you lend at interest (ribâ) for the sake of increasing (li-yarbuwa) your property will bring you no increase (lâ yarbû) in the sight of God, while what you give away as alms (zakât) in seeking the face of God will bring many times its value.”(Surat Rum 39), There is not yet an explicit condemnation but holy book motivates people not to apply interest for social justice.[36]

“Those who feed on usury will only rise again (on the last day) like those possessed by the devil. They say in effect, “usury and selling are the same thing”, whereas God permits selling but forbids usury… God will reduce interest to dust while making alms fruitful…O you believers, fear God, renounce the excess of usurious interest, if you really believe. If you do not follow this ruling, you may expect the hostility of God and of his Messenger. If you repent, you will retain your capital, neither harming anyone else nor suffering harm yourselves. To a debtor in difficulty, grant a delay until his situation improves. And if you renounce your rights that will be better still.” (Surat Baqara 275-280). This is a fundamental passage for our present reflection. One may list the following points: The clear distinction between commerce and ribâ; Ribâ is condemned by God, while on the other hand he encourages almsgiving; Faith implies the renunciation of usury; Nevertheless,

[34] Noorzoy M. S.(1982). Islamic Laws on Riba (Interest) and Their Economic Implications. International Journal of on Middle East Studies 14,p. 3-17
[35] Mavrakis N.(2009). Islamic Finance; a Vehicle for Development. University of Texas e-book, 3
[36] Renaud E., Islamic Banks e-book, 1

capital will be safeguarded; and lastly, one may not put pressure on people who are in difficulties.[37]

1.1.5.2 Interest in Hadiths (Prophet's Words)

Second main source of Islam is Prophet Mohammad's hadiths. Also there are some hadiths about prohibition of Riba. ‘’ The Prophet forbade living off interest and causing others to do so’’ and The Prophet is said to have repeated the ban on usury during the farewell pilgrimage: “God forbids usury. It will remain unlawful up to the resurrection.” But he also concerned about Muslims and said’’ “Certainly a time will come when a man will not be concerned to enquire whether the money he is handling comes from a lawful or an unlawful source.”[38] We can see that prophet knows one day economic conditions will change and usury –riba- will be prevalent. Also Muslims will have to use usury or Riba.

Debates over Riba continued after die of prophet because some properties of riba did not explained in detail. Umar who is the second caliph of prophet Mohammed concernedly shows this unexplanation by saying’ the verses which treat of ribâ are among the last revealed verses of the Koran, and the Prophet died before he explained their meaning. You should therefore abstain from what is doubtful and adopt what will not give rise to any scruple.’’ He also said samething ‘’I would have preferred that the Prophet had given you definite explanations, so as to eliminate all controversy concerning certain cases of ribâ’’[39]

Islam prohibits riba for two main reasons: to promote the sharing of risk and reward and to promote economic and social justice. The prohibition or riba aims to protect individuals from becoming excessively indebted and from paying or receiving unfair compensation for giving or receiving credit. The interest Islam as a religion promotes the idea of equality among all believers in God's eyes, rather than superior standing for religious leaders. In the same vein, the Islamic economic

[37] Renaud E. Islamic Banks. e-book, 1
[38] Renaud E. Islamic Banks. e-book, 2

system aims for socioeconomic justice among its members by promoting economically just and ethically and morally correct economic behavior. The main way the Islamic economic system accomplishes this is through the prohibition of riba. By prohibiting riba, each member in a contract gets a fair and equitable return, which ultimately leads to socioeconomic justice throughout society.[40] Quran also mentions about lenders and borrowers justice. If someone put interest to his money which lend no one can know at which percent the business has profit by interest lenders' profit is arranged before business so if interest rate is above profit borrower will have injustice, on the other hand if profit is below than interest lender will have injustice. For example interest is %10; lender will get %10 profit even if investment had loss so borrower will collapse totally. On the other hand if investment had profit %30 this time borrower will gain more than lender by lender's capital so lender had injustice. Islam tries to prevent lenders 'or borrowers injustice. Risk sharing is another important issue for business. If there is interest risk is owned by borrower because nobody can guarantee investment will have business. Economic conditions always fluctuate and contain risk. Interest makes investment more risky.

1.1.5.3 Economic Aspects of Interest in Islam

Lender only gives capital and waits for his interest does not curious about how business is going but borrower has to have profit at least to give lender's money. This makes aim gap between lenders and borrowers. Aim gap also concluded social problems between capital owners and other layers of the society. Socialism grew by hate of poor workers to rich capital owners. By interest capital owners always gain from economic activities but who does not have capital, has risk to get profit or not this concludes money is collected by same people and income equality disrupted.

Constructing models of business organizations which show earnings of variable dividend income declared from profits instead of earning fixed interest income from bonds and debentures is not problematic.' However, before such models can be put into operation to meet the requirements of Islamic laws on riba, the methodology of calculating total costs under standard assumptions (where the

[40] Mavrakis N.(2009). Islamic Finance; a Vehicle for Development. University of Texas e-book, p. 3

business concern employs physical capital and attempts to minimize costs by obtaining an optimal mix of the different factors of production including capital) must be worked out. This has not been done in the literature on riba. The Islamic model of a business concern using physical capital considers capital a factor of production and, therefore, in the calculations of optimal factor combinations and in the calculation of total costs the purhcase price of capital good or its rental can be used. This means that the standard assumptions of economic theory are accessible to business concerns in Islamic societies, except for allowing the raising of funds through interest-bearing loans in order to meet capital costs. Capital costs can be met from the sales of shares (which in turn can earn dividends as a lawful incentive) and business savings-internally generated funds from undistributed profits and the depreciation allowance.[41]

Including Adam Smith most of economist mixed interest and profit, called these two concepts as the same. For example Samuelson one of the famous economists used interest and profit as same concepts in his book named ‘economics’. According to Samuelson interest and profit are the same if there is no ambiguous environment. Profit is equal to interest rate plus risk premium. If there is no ambiguous environment risk premium is zero so interest and the profit is equal.[42]

A common misconception of usury is that it is only aimed to prevent excessive interest rates or compounding of interest over time. In Christianity and Western thought, as shown below, that definition of usury has only arisen since the Protestant Reformation. Before then, usury was defined as charging any rate of interest, not just exorbitant rates. In Islam, the confusion has also arisen because of misinterpretations of the Quran, which says, “Do not devour interest doubled and redoubled.”

Many people argue that interest can be charged because it is merely an adjustment for inflation or an indexation to changes in consumer purchasing power. Shariah

[41] Noorzoy M. S.(1982). Islamic Laws on Riba (Interest) and Their Economic Implications. International Journal of on Middle East Studies 14, p. 3-17
[42] Özsoy İ.(1993). Faiz ve Problemleri, İzmir: Nil Yayınları, p. 31

allows indexation for adjustments of wages, salaries, pensions, etc., but it does not allow indexation of financial assets for three reasons. First, the Quranic verses dealing with riba clearly state that only the principal of a loan must be repaid; anything above that is considered riba. Second, due to the presence of inflation in the economy, a lender’s purchasing power would be at stake regardless of if the money was lent as a loan, invested in a return-bearing security, or kept for consumption purposes. Therefore, it is unjust to require the borrower to bear this loss since the lender would have borne this loss anyway. Lastly, some scholars have argued that there is no perfect index to use since the economic conditions of different cities and regions across countries and around the world experience inflation at different rates.

Many mistakenly believe that, by prohibiting interest on loans, Islam denies the concept of the time value of money. However, the Shariah does recognize the time value of money, but it places limitations on its use. Shariah allows for compensation based on the time value of money for sales contracts, discussed in further detail below, but not for loans. Time by itself does not produce a yield; rather, money invested in a business over time produces a yield. If a person chooses to invest his or her money in a business, then he or she will receive the proportionate share of the profits or losses as a result of the investment in economic activity. Since profits or losses are not fixed beforehand, an interest rate cannot be fixed beforehand.[43]

Some Academicians like Erhan Kula claims that Islamic communities could not be successful in capitalist world because of prohibition of interest. Islamic saving could not be transmitted to investment. Muslim people buy gold or other valuable metals to protect their money value. And say: ‘’In modern and fairly well functioning market economies savers time preference rates are brought together with borrowers’ opportunities to invest. One of the main functions of the commercial banking system is to channel savings into investment projects, a process that rewards both parties. Unfortunately, in a good part of the Muslim world saving is not diverted into

[43] Mavrakis N.(2009). Islamic Finance; a Vehicle for Development. University of Texas e-book, p. 6-8

investment projects because Muslims are guided, or misguided, by fiqh, the knowledge of legal injunctions applicable to individuals' actions that interest rate offered by commercial banks is the forbidden riba, Fatwa on Riba. Such publications are flawed for they make no reference to the modern interest rate theory that contains concepts of the time preference rate and the opportunity cost of profit forgone. As a consequence, some Muslims instead of depositing their money with the commercial banks are keeping it in the form of gold, precious stones and hard currency and as a result starving business projects of finance undermining the much needed economic development in their countries. Expansion of businesses creates many opportunities to elevate poverty a case that is ordained by the Koran in a forceful and unambiguous language.''[44] But Islam does not encourage buy valuable metals to protect money's value but share risk by being participant to business, not put interest. Buying valuable materials is conclusion of Muslim world laziness.

It is certain that in the Ottoman Empire that extended itself on three continents advancing and borrowing of money amongst traders, artisans, public servants and the population in general was quite widespread, partly due to the special texture communities comprising the Empire and because of the Imperial land system the in progress.

The great majority of the Ottoman Turks belonged to Hanafite Sect. Books entitled Multakd al-Abhur and Durar wa- Gurar, lead the fiqh books used as text books in Ottoman madrasas (school) and to which kazis (judge) frequently referred when pronouncing their judgements or ruling their verdicts In Multakd, a whole chapter devoted to the discussion of riba mentions the six articles given in the Hadith, namely gold, silver, wheat, barley, date and salt and following a statement to the effect that in riba exchange of any article with an excess of the same good is not permissible, examples are provided.

[44] Kula E.(2008). Is Contemporary Interest Rate in Conflict with Islamic Ethics?, Authors Compilation, London: Blackwell Publishing

The Galatian money-changers who were as influential abroad as they were at home proved very active in extending credits on interest and two of them had indeed set up the first bank in Turkey. In 1845 the Ottoman Government signed a contract with two money-changers, J. Alleon and Th. Baltazzi, to the effect that the Government undertook to pay them 2 million kouroushes per annum in return for their pronounced and explicit promise to keep the value of one Pound Sterling at 110 kouroushes.[45]

We see that before capitalism arisen Ottoman Empire did not use interest in its state transactions. When Ottoman Empire's financial situation got worse and interest began to use more prevalent, Ottomans had to use interest in their state transactions.

To sum up, Interest in Islam is one of important debate in Muslim world and will be argued In the future. Some people accepts interest is same with riba but some others say that interest and riba are different concepts after this discrimination they say today interest is not prohibited, riba prohibited by Islam. They have failed to explain why interest is different from riba, because as mentioned above interest and riba basically same excess value of debt.

1.1.6 Modern Interest Theories

After arise of capitalism in all over the world, interest became more prevalent so interest theories began to grow up. Academicians tried to logical expression of interest because all of religions prohibit interest someone should convince people that interest should not be prohibited. Interest is the core of capitalism if people do not lend money how entrepreneurs get credit and make investment. They were not aware of interest collect money to one part of public.

One of the main contributors to interest theory is john Maynard Keynes. He tried to explain why interest is exists in his 'liquidity preference theory'. He saw

[45] Çagatay N.(1970). Ribā and Interest Concept and Banking in the Ottoman Empire,Studia Islamica 32,p. 53-68

interest is the value of money. If somebody renounces to use of his money and lends it to anybody he deserves extra amount to his renouncement. Interest is not the value of saving but value of giving up from holding money. He wrote in his famous book The General Theory of Employment, Interest and Money that (1936) ’’ in what form he will hold the command over future consumption which he has reserved, whether out of his current income or from previous savings. Does he want to hold it in the form of immediate, liquid command (i.e. in money or its equivalent)? Or is he prepared to part with immediate command for a specified or indefinite period, leaving it to future market conditions to determine on what terms he can, if necessary, convert deferred command over specific goods into immediate command over goods in general? In other words, what is the degree of his liquidity-preference—where an individual's liquidity-preference is given by a schedule of the amounts of his resources, ‘’valued in terms of money or of wage-units, which he will wish to retain in the form of money in different sets of circumstances?’’[46] after these questions he answers these questions too’’ Thus the rate of interest at any time, being the reward for parting with liquidity, is a measure of the unwillingness of those who possess money to part with their liquid control over it. The rate of interest is not the 'price' which brings into equilibrium the demand for resources to invest with the readiness to abstain from present consumption. It is the 'price' which equilibrates the desire to hold wealth in the form of cash with the available quantity of cash;—which implies that if the rate of interest were lower, i.e. if the reward for parting with cash were diminished, the aggregate amount of cash which the public would wish to hold would exceed the available supply, and that if the rate of interest were raised, there would be a surplus of cash which no one would be willing to hold. If this explanation is correct, the quantity of money is the other factor, which, in conjunction with liquidity-preference, determines the actual rate of interest in given circumstances. Liquidity-preference is a potentiality or functional tendency, which fixes the quantity of money which the public will hold when the rate of interest is given; so that if r is the rate of interest, M the quantity of money and L the function of liquidity-preference, we have M = L(r). This is where, and how, the quantity of money enters

[46] Keynes J. M. (1936). General Theory of Employment, Interest and Money, www.econlibrary.com

into the economic scheme.’’[47] On the other hand he claims that interest rate is zero in ideal economy because if interest rate is over than zero investors will consider that whether they can earn more than interest rate by doing business.

Economist Irving Fisher distinguished interest of money and interest of other goods. He said in his book Theory of Interest (1930) ‘’we thus need to distinguish between interest expressed in terms of money and interest expressed in terms of other goods. But no two forms of goods can be expected to maintain in an absolutely constant price ratio toward each other. There are therefore theoretically just as many rates of interest expressed in terms of goods as there are kinds of goods diverging from one another in value.’’ Fisher also saw interest as value of holding money, if someone renounces to hold money and give money to another person so he renounced holding money and deserves extra amount. Fisher especially known as inventor of real interest rate. According to Fisher real interest rate is difference between nominal interest rate and inflation rate. Fisher could not explain why borrower gives extra money to lender if value of money increased. For example there may be e deflation and value of money increase so borrower of money loses because of borrowing.

French economist who is famous about’ supply creates its own demand’ J. Baptiste Say contended that money is a neutral mechanism through which aggregate supply is transformed into aggregate demand. He viewed money as an intermediate good or conduit that enables people to buy. Like Menger, Say described the spontaneous evolution of a commodity to become money. He favored commodity money and free banking. In Baptiste Say’s system, money serves chiefly as a medium of exchange and was not explicitly identified as a store of wealth. Say denounces state manipulation of money through debasement of the value of currency. He observes that such manipulation of monetary values confuses the pricing system. He viewed inflation as a monetary phenomenon rather than the result of excessive employment and economic growth. Say viewed interest rates as the price of credit. He understood that market-determined interest rates perform the

[47] Keynes J. M. (1936). General Theory of Employment, Interest and Money, www.econlibrary.com

function of a market clearing price for money. However, he did not explicitly recognize or discuss the relationship between interest rates and time preferences as did the later Austrian thinkers.

After arise of capitalism in 17th century a lot of interest theories grew up. The most important ones are the 'Time preference theory' which is written by Bohm-Bawerk. Bawerk states that humankind prefers today to tomorrow. Today's cash is valuable than tomorrow so there must be an acio between today's value and tomorrow's value. He sets two assumptions about humankind and claims theory based to these assumptions these are; That mankind generally esteem present pleasure above future pleasures, including those derived from the consumption of goods; that different estimations of present and future pleasures derivable from goods are the same thing as different estimations of the present and future goods themselves, and not only so, but that they are the same thing as different estimations of goods obtained, and to be obtained, through the process of capitalization. After these assumptions Bawerk claims that there should be 'acio' between today's pleasure end tomorrow pleasure so he concludes interest is the value of renouncing today's pleasure for tomorrow pleasure. This theory is accepted by most of the academicians. He is correct about people prefers today to tomorrow but no one can know if today is valuable or tomorrow is valuable for example coal is not valuable in summer but it is so valuble in winter. Winter comes after summer so not always today's goods are valuable than tomorrow.[48] Bawerk claims that acio between today and tomorrow always positive but in some circumstances acio may be negative.

Although these theories seem logical they cannot explain some parts of interest. Interest is put before transaction occurs for example one party has to pay interest unless he had loss from business. Some says that interest is payback of inflation rate if someone lend money and don't put interest he will be victim of that lending. Nevertheless, Economy is not static but dynamic so economic conditions always changing and no one can know at what percent inflation rate will be. Participation in business is the best way for shouldering business equally and

[48] Özsoy İ.(1993). Faiz ve Problemleri. İzmir: Nil Yayınları, p. 118

bearing risk equally. Profit of business divided by capital owner and labor owner so no one will have injustice. Participation will also bring psychological partnership between capital owner and labor owner; socialism had grown because of hate of labor to capital owner. If earnings divided equally both parties try to produce more and equity of earnings will occur.

The other reason of interest in today's world is consuming demand of people. Advertisements, cinemas, TV programs encourage to consume so people wants everything they can buy. They go to banks get credits and consume. Rings of capitalism round by consume. If there were no consumer production could not be happen.

1.2 Profit

An economic profit arises when revenue exceeds the opportunity cost of inputs, noting that these costs include the cost of equity capital that is met by normal profits. If a firm is making an economic loss (its economic profit is negative), it follows that all costs are not being met in full, and the firm would do better to leave the industry in the long run. In terms of the wider economy, economic profit indicates that resources are being employed in useful endeavors, while economic losses indicate that those resources would be better employed elsewhere.[49] Profit is basically difference between earning of business and cost of business if substitution is positive we there is profit, if negative we say loss. We should define profit extend to its sources and results because profit is misinterpreted with interest some argues that interest is a kind of profit.

In free enterprise economies the sum of the contractual factor payments when deducted from the revenue product of the firms leaves a surplus that goes to the entrepreneurs. This surplus is akin to the accounting gross profit. A part of it represents capital compensation which incidentally the market forces are powerless to determine. Capital compensation, however arrived at, is taken out of the gross

[49] www.wikipedia.org (9 May 2011)

profit to arrive at its 'net' component. This definition of profit is too abstract and microscopic. The concept of normal profit has an ethical import. But in the real, dynamic situation normal and pure components of the surplus are extremely difficult to seperate; even conceptually It comes about that profit defined as a surplus of business earnings over contractual payments is a non-functional surplus whose origin lies essentially in progressive dynamic change. The real issues in profit theory are (i) whether contractual payments, especially wages, as determined by the market forces. can be shown to be just and (ii) whether the utilization of the residuum in the hands of the entrepreneurs is always proper. The entrepreneurs translate their decisions into action by hiring the other factors of production. The services of the hired factors do not involve, says Knight, the exercise of judgment in the same sense as it does in the case of the entrepreneurs (Knight, pp. 270-72). They work for the entrepreneurs in return for their contractual payments. The objective requirement for entrepreneurship, according to Knight (pp. 198, 363-64) is the possession of property since no empty handed person can ensure contractual payments to the hired factors of production. This view of the entrepreneur makes profit the reward for making business decisions in the face of uncertainty, and is a legacy of the classical model of the tiny owner-operated business units. It fits well even today to cases of small business. But since the rise to dominance of the modern corporate form of organization both the functions and the identity of the entrepreneurs have come under heavy fire Islam is not opposed to wage labor but it does insist that the wage contract should be an equitable one. Workers must have the fairest possible chance under the arrangement to receive their due.[50]

The Islamic ideal of economic justice seems to be the achieving of a situation where in what each factor ultimately gets is what it contributes to total output. The Qur'an explicitly declares: "God created the heaven and the earth for just ends, and in order that each soul may find the recompense of what it has earned" (45:22). Islam aims at shaping all exchange relations among people on the principle of cooperation,

[50] Hasan Z.(1983). Theory of Profit:The Islamic Viewpoint, Journal of Islamic Economics, 1

mutual benefit, and fair play (4:29-30). It directs men not to expose themselves or inflict on others loss that is possible to avoid.[51]

1.3 Rent

Rent could be defined as payment, usually monthly for use of space or property. [52]Renting or hire is the sale or purchase of the benefits/services of physical assets or resources including human resources. The assets or resources that generate benefits in the form of real goods (like tree giving fruits or animals giving milk) cannot be rented for such benefits. Financial resources cannot be rented because they cannot generate any service without being "consumed".[53]

Rented goods should generate permitted economic benefits which should be definitely known. Where there is any doubt about the nature or amount of the benefits or the benefits are uncertain, then the goods cannot be rented. Again the reference is to the service for which the resources have been rented to provide and not to the output that is produced by using this service. For example, if a machine is being hired for producing a certain good then its capacity to produce such goods should be definitely known. No goods can be rented which are prohibited or which generate prohibited services or are capable of producing only prohibited goods. Maintenance of the rented resources to maintain the flow of benefits/services for which the resources have been rented is the responsibility of owner. Any loss or damage to the property not wilfully caused by the tenant is to be borne by the owner. The resources will cease to be on fee as soon as they become or are found to be incapable of providing the service for which the resources have been rented.[54]
Sukuk is based on rent income. In sukuk origin of income is rent not interest because of this situation sukuk return is not paper based earning. It will be explained sukuk structure and sukuk implementation.

[51] Hasan Z.(1983). Theory of Profit:The Islamic Viewpoint, Journal of Islamic Economics, 1
[52] www.investorwords.com
[53] Khan M. F.(1990). Factors of Production and Factor Markets in Islamic Framework, KAU: Islamic Econ, P. 2
[54] Khan M. F. (1990). Factors of Production and Factor Markets in Islamic Framework, KAU: Islamic Econ,p. 2

1.4 Comparison of Interest-Profit-Rental Fee

Some people have misconceptions about interest, rent and salary of capital. Some people argue that application of interest in Prophet Mohammad’s period and now are different. Some types of interest are not rib a and Islam did not prohibit them. First of all we should explains these misconceptions and explain differences of them.

These are serious issues and involve intricate problems of definition and value judgment. The distribution of national product thus assumes a prime position among the economic issues of a nation. Probably, this was the reason which led Ricardo to declare that discovery of laws which regulate distributive shares is the 'Principal Problem in Political Economy'. Unfortunately, 'this principal problem' has been one of the neglected areas of economic analysis. Ricardo divided the national output into three components - rent, wages and profit. Rent was determined by the differential fertility of land, wages by subsistence and profit as residual. The marginal’s economists viewed the problem of distribution as pricing of factors of production. Wage was the price of labor, interest of capital, rent of land and profit was again viewed as residual. The marginalize approach is based upon the marginal productivity Theory. Wage is equal to the marginal productivity of labor and so on with each input.[55]

Profit is difference between the income of the business and all its costs /expenses. It is normally measured over a period of time. Profit comes from real economic value so it is different from interest. Marx who is the founder of socialist system, differentiated profit and interest. He said ‘exchanging money with money is not appropriate origin of money so money lender deserves the most hate’.[56]

As for the relationship between interest and profit; profit is a surplus to assets, shared between capital and entrepreneur, resulting from investing a certain amount of money in an economic activity such as agriculture, industry and commerce, and then

[55] Ausaf Ahmad(1984). A Macro Model of Distribution in an Islamic Economy, Journal Research of Islamic Economnics, p. 2
[56] Marx C.(1965). Capital. Moscow: Progress Publishers, Vol. 1, p. 164

it is re-transformed whether into a larger sum (where profit is realized) or, a lesser sum (where actual loss is suffered). Thus, profit and loss are twins. Profit is a result and consideration of an actual supplement and contribution to the revenue of the community by capital coupled with entrepreneur. When the owner of capital participates in a business only with his capital, he has to take risks of loss in that business to deserve a profit. Therefore, profit can be seen as the return for bearing risk. For, after all, business is subject to failure; so in profit, the principle is: *"nothing ventured, nothing gained"*

In profit, when the investment results in a loss, the owner of capital is directly affected by it, whereby the community is affected indirectly. But, interest is an income given to money loaned, in any case, even when it does not add any value to the assets, or revenue, of the community. In interest, when there is a loss, capital is not affected by it, although that loss directly concerns the capital itself and all the community is affected by it. That is to say, interest income may be earned at the expense of all others in the society. Interest may be 'taking without giving' while profit is made only when the capital contributes to the community and in proportion to its contribution.[57]

Rent and interest are also different concepts. Interest is over value of money which has no reciprocity but rent is the value of material, concrete thing. If there were not rent people do not have inception to build apartments or any building. Nevertheless, if there were no profit economic activity would not occur. Profit and interest is different concepts also. By profit entrepreneur has incentive to make business. Profit is gained by increasing time utility, land utility or good utility. For example if a trader earns money by collecting vegetables to another city and sell them more than he bought, he had profit because of increasing land utility of that vegetable. If a trader hides vegetables in a refrigerator until summer and sell them when they are rare and had profit by this activity he had profit because of increasing time utility of that vegetables. But in interest utility of nothing increased only amount of money which does not have reciprocal value is exchanged.

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[57] Ozsoy I. (2010). ' Islamic Banking: Conceptual Fundamentals and Basic Features' Economical Herald Quarterly,

What is the difference between who buys building and desire rent for it and desiring interest for that amount of capital for example by 1 million USD? Mercantilist thinkers had wrote that these circumstances are the same so interest should not be prohibited because of religion. But these are different concepts, in interest money does not have own value and no one can not benefit from money without decrease of amount of money. In rent, rented material has its own using value and it can be used without decrease of its amount. According to Islam rent and interest are different concepts. We can see this using value in gold or silver rental. Gold and silver were used to instead of money in Middle Ages. In Islam renting gold or silver is not interest if rented for good looking but if gold or silver rented for using in trade it is prohibited because of interest.

The element of differentiation between interest income and rental-fee depends on the fact that if the thing is non-consumable and capable of being used without changing its essence and without damaging its intactness, the benefit received from it would be a good consideration for the rental-fee. This benefit may be a service rendered by persons or a usufruct (right to use) of things. On the other hand, where the borrowed/rented thing is consumable and perishes when it is used, -as in the case of money, food, and drink-, the rental paid for the use would be in excess of what is owing, that is the principal, by the lessee. This excess so paid is interest, regardless of the fact that it is called ‘rental’. This is because the advantage of the rented thing - which is no consumable-, is certain, for it is always ready to be used in any case, and it is strongly possible for it to be handed over by the lessee to the lessor.[58]
Time value of money is different from time value of capital. Capital is productive we accept it but money is not productive. If you put money n somewhere and wait money cannot increase by itself. For value increase capital and labor should be connected.

[58] Ozsoy I. (2010). ‘ Islamic Banking: Conceptual Fundamentals and Basic Features’ Economical Herald Quarterly

1.5 Conclusion

Interest theories try to prove why interest is useful and logical but could not explain some aspects of interest. Three holistic religions forbade interest. In interest one of party lender or borrower will have unfairness because profit cannot be known before business but interest sets a unique profit margin to capital. For example interest rate has set at %10 rate but business could not have profit and lose its capital. Despite loss capital owner will have its profit through interest. On the other hand interest rate is set at % 10 rate buy business had %40 profit so capital owner (lender) will have unfairness. If profit is divided between capital and labor both parties would have %20 profit. In this situation capital owner had unfairness.

Secondly, time is not indicator about economic situation. Goods and services may get more valuable sometimes but especially at recession times goods' and services will not get more valuable their price will decrease so time preference cannot explain logic of interest. For example coal is expensive at winter times but not expensive as winter at summer. So always time does not really refer to value.

Some people assume that the prohibition of riba during the time of the Prophet Mohammed was aimed only at consumer lending in order to provide justice to the people in lower socioeconomic groups, not at commercial lending. However, this is a misconception and is refuted by two pieces of evidence. First, agricultural loans, which are commercial loans, were common at the time of the Prophet. The prohibition of interest aimed to eliminate the interest charged on these loans. Second, the businesspeople of Mecca, Saudi Arabia, where the Prophet Mohammed lived, were part of a sophisticated network of traders who often times took out riba-based loans to finance their trade expeditions. The Prophet signed an agreement with a group of moneylenders to abolish the use of riba-based loans. Therefore, citing this evidence, the prohibition of riba is aimed at both consumer and commercial loans.

Interest is harmful for the society. If interest is prevalent capita owners will have excess gain and they does not bear risk they only give money and waits for his interest so capital owners and workers will divided in society. Capital owners do not affected by economic situation. They are indifferent on economy is going well or not. Capital is collected by capital owners by usage of interest.

On the other hand after arise of capitalism it is impossible to abandon interest at one day. All states and firms use interest as normal process of their work. Today most of people pay interest involuntarily.

Interest can be abolished by increase of people trust to each other. Some Islamic nations such as Pakistan, Iran tried to abolish interest by laws but it did not work. They returned to interest system after collapse of system. Interest is prevalent because no one lends money to anybody so people go to banks to find money. Banks are the most profiting firms in capitalized world. Magazines and newspaper wrote interest rates every day. It can be say that capitalism based on interest. Some people have excess fund –they saved more- and some people needs that fund.

CHAPTER 2

2. ISLAMIC (INTEREST-FREE) BANKİNG

In this chapter we will describe Islamic banking. Sukuk is an Islamic finance tool and origin of Islamic finance or the first implementation of interest free finance is Islamic banking so we should explain Islamic banking before the sukuk. Islamic Banking should be understood for sake of understanding Islamic finance. Principles of Islamic banking will be defined. Islamic banking has some principles due to convenience to Islam –no interest-. Financial methods such as murabaha, mudarabah, musharakah are implemented in Islamic banking. All these methods will be explained. Implementation of Islamic Banking will be also explained because Islamic banking applications differ from country to country.

2.1 Definition of Islamic Banking

There is no universal definition of Islamic Banking, as Warde (2000) points out:''*No definition of Islamic finance is entirely satisfactory. To every general criterion, a financial institution owned by Muslims, catering to Muslims, supervised by a Sharia Board, belonging to the International Association of Islamic Banks (IAIB) etc., one can find some significant exception*"[59]

However, several authors have tried to give an idea of what Islamic Banking includes, and for what it stands. Among these explanations, the one by the State Bank of Pakistan seems to be quite comprehensive:'' *Islamic Banking has been defined as banking in consonance with the ethos and value system of Islam and governed, in addition to the conventional good governance and risk management rules, by the principles laid down by Islamic Sharia. Interest free banking is a narrow concept denoting a number of banking instruments or operations, which avoid interest. Islamic Banking, the more general term is expected not only to avoid interest-based transactions, prohibited in the Islamic Sharia, but also to avoid*

[59] Warde I. (2000). Islamic Finance in the Global Economy. Edinburgh University Press, Edinburgh

unethical practices and participate actively in achieving the goals and objectives of an Islamic economy"[60]

Islamic Banking indicates a banking system that operates in compliance with the rules of the Sharia, which aims to provide economical and social justice for all members of society. The entire economy is based on these principles. The Islamic financial system is part of the whole concept of society; religion and economy cannot be separated from each other. The main characteristics of Islamic Banking are the prohibition of riba (interest), gharar (speculation) and maysir (gambling). Furthermore all transactions that involve an action forbidden by the Sharia are prohibited.[61]

Islamic Banking is a mixed concept and it is hard to explain what is the Islamic or participation banking. Pakistan state bank defines Islamic banking as ''Islamic Banking has been defined as banking in consonance with the ethos and value system of Islam and governed, in addition to the conventional good governance and risk management rules, by the principles laid down by Islamic Sharia. Interest free banking is a narrow concept denoting a number of banking instruments or operations, which avoid interest. Islamic Banking, the more general term is expected not only to avoid interest-based transactions, prohibited in the Islamic Sharia, but also to avoid unethical practices and participate actively in achieving the goals and objectives of an Islamic economy "[62] This definition could be quite comprehensive.

Interest is prohibited in Islam but banking operations includes not only credit but also other banking operations such as electronic fund transfer, money order, letter of guarantee…Today trade has globalised and all firms need banking operations to buy or sell goods so Muslims need these operations too. In order to correspond to these need, different type of banking system found named Participation Banking

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[60] What is Islamic Banking? State Bank of Pakistan, December (2005) www.bankislami.com.pk/JSP/en/faq.jsp

[61] Aichbichler E.(2009). İslamic Finance in Switzerland and Germany, Vienna

[62] State Bank of Pakistan, (2005). What is Islamic Banking? www.bankislami.com.pk/JSP/en/faq.jsp

found. Islam accepts that trade ca not be made by only cash so Islam allows trade by time bargain. According to Islam base of trade should not be debt but own capital is important so risk is hold by owner of capital or by participation risk is shouldered by both parties.

In the early stages of Islamic history, throughout the Western Middle Ages, Islamic banking thrived in the Muslim world. During this time, the Muslim world was the dominant region in terms of trade, access to resources, and intellectual development and research. As such, Islamic banking thrived. However, as Europe increased in economic and military prominence, starting with the Crusades, Western banking practices began increasing in prominence as well, until Islamic banking was virtually eliminated for the next several centuries. After Muslim countries obtained independence from European colonizers in the early- to mid-twentieth century, Islamic countries had a renewed interest in returning to Islamic banking principles. While several attempts were made in the mid-twentieth century to revive the Islamic banking industry, the major catalyst for the development of what can be called the modern Islamic banking industry was the creation of the Islamic Development Bank (IDB) in 1975. The IDB was founded as an international finance institution with the backing of the then 23 member nations of the Organization of the Islamic Conference.[63] Its goal was and is to foster economic development and social progress in its member countries while maintaining adherence to Shariah Islamic law. Between 1975 and 1990, the Islamic finance industry matured into a viable alternative to conventional banking. New Shariah-compliant financial instruments were developed, and their practicality was confirmed with the successful use of these products by three types of institutions. First, three countries, Pakistan, Iran, and Sudan, completely eliminated conventional banking practices within their countries , established Islamic banking systems. Second, scores of Islamic financial institutions were founded within countries that operated on conventional banking systems. Finally, several important multinational banks began offering Shariah-compliant products, in addition to conventional banking products. This move showed that conventional banks increasingly viewed Islamic banking as a viable alternative to

[63] www.isdb.org

conventional banking and an important shift in banking practices. The development of infrastructure institutions to support the Islamic finance industry began in the 1990s. This development was an outgrowth of the difficulties Islamic banks faced trying to operate in a conventional banking system.

Since the opening of the first Islamic bank in Egypt in 1963, Islamic banking has grown rapidly all over the world. Islamic banking operations started out as a mere deposit taking and lending facility and has since transformed into all aspects of banking, money and capital market operations, including fully fledged stock exchanges. This was further intensified by the 1975 oil price boom, which introduced a huge amount of capital inflows to Islamic countries. In fact, two Islamic nations, Iran and Pakistan, completely abandoned the conventional banking system and converted their entire financial operations to Islamic practices and claim to be devoid of conventional interest based financial transactions.[64]

The early 1960s saw two significant developments. The first experiments in Islamic banking were developed at this time, in Malaysia in the form of a fund to assist those going on the Hajj pilgrimage to Mecca, and in form of a bank developed in the town of Mit Ghamr in Egypt, based on the European savings banks models. Notably this bank did not identify as 'Islamic' to the German government that put up the initial capital, nor to Nasser's secular authoritarian state, which it ran afoul of anyway. Ironically, the Mit Ghamr bank would probably not be identifiable as an Islamic financial institutions opened in neighboring countries in following years, including the Kuwait Finance House, the Bahrain Islamic Bank, and the Qatar Islamic Bank and so on. Islamic financial institutions also wasted no time setting up in the tax havens of the world, in the Bahamas in 1977 and Luxembourg in 1978.[65]

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[64] Mavrakis N.(2009). Islamic Finance; a Vehicle for Development. University of Texas, e-book, 11
[65] Abraham I.(2008). Riba and Recognition: Religion, Finance and Multiculturalism. Essays from AASR Conference , p. 2

2.2 Principles of Islamic Banking

First of all participation banks should be apparent to Islamic rules. If a participation bank does not apply Islamic rules there would be no difference between Islamic banks and private banks. One of these principles is profit, loss should be shared. This leads to risk should be shared by two parties. Second Islamic bank should avoid interest (riba). Islamic banks found for Muslims so that they can avoid prohibited interest. Islamic bank should not invest in haram (forbidden) products. This relates to what sort of enterprises will be financed by Islamic capital and what it is permissible to invest in. Obviously things such as alcohol, pig are haram for Islamic investors; nor can one invest in conventional finance, since this would be self-defeating. Weapons are considered haram, and many Islamic mutual funds will also avoid entertainment companies producing films or music. Highly leveraged companies are also avoided given that indebtedness is anathema to Islamic finance. The real problem is trying to avoid conventional finance in investing, the other law of islam has to be obeyed which is called zakat. The financial institution must pay zakat – This is alms of 2.5% for relief of poverty. It is considered one of the five pillars of Islam.

Islamic finance should have ties with real economy. Here real means which related to concrete goods or services not speculation or financial bubbles. Islamic finance always ties itself back in to what is called the 'real' economy. The last principle of Islamic banking is all banking activities should be over seen by advisory board (Sharia Board). Bank employees can ask what they want to advisory board so all activities should be seen by Sharia Board.

Islamic finance integrates Islamic moral and ethical principles and, as such, prohibits financing harmful products and activities. For example, Islamic Banks prohibit financing to industries such as alcoholic beverages, tobacco, casinos, and pornography. Islamic banks do not participate in financing activities that are harmful to society and that would consequently hinder development. By following this principle, Islamic banks improve the productivity in the economy and reduce the social and economic costs of such harmful products and services.

2.3Applications of Islamic Banks

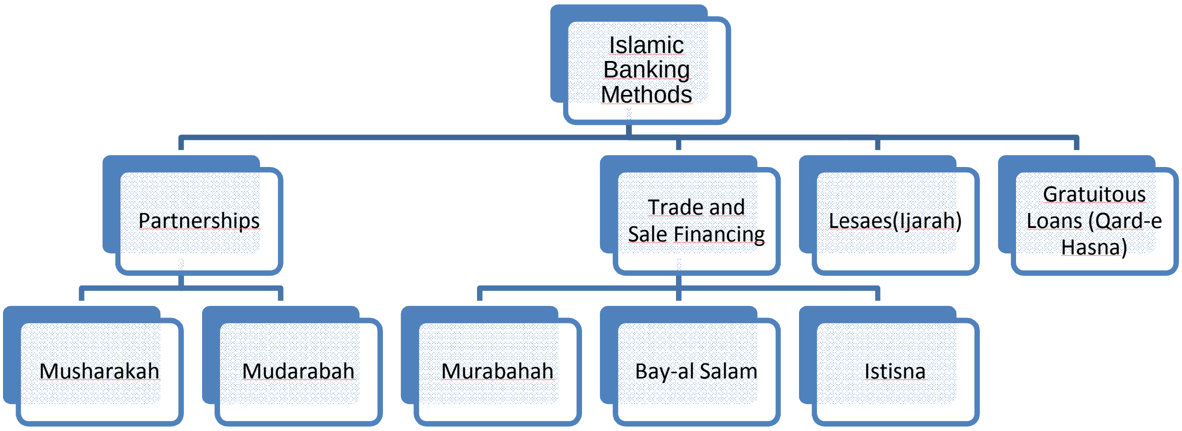


Figure 1

The Islamic banking sector holds 84 percent of all Islamic assets. Islamic banking instruments can be broken down into four groups: partnerships, trade and sale financing, leases, and gratuitous loans.

2.3.1 Partnership

In Islam, the ideal way to finance any operation is through a partnership, which provides the most equitable distribution of risks and rewards. The mission of Islamic banking is to justly share risk and reward between the lender and the borrower.

2.3.2 Musharakah

Musharakah is word of Arabic origin which literally means sharing. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture. It is an ideal alternative way to interest based with far reaching effects on both production and distribution. In the modern capitalist economy, interest is the sole instrument indiscriminately used in financing of ever type. Since Islam has prohibited interest this instrument cannot be used for financing of any kind. [66]

Musharaka financing, where the entrepreneur and the bank jointly supply the capital and manage the project. Losses are born in proportion to the contribution of capital while profit proportions are negotiated freely.[67] Musharakah agreement provides both parties to negotiate and set profit ratio freely and fairly. In Musharakah there is no setting profit of one party before business like interest so if business get bankrupted both of parties get hurt. Musharakah helps to divide income fairly to society.

For example Ali and Veli had agreed on musharakah agreement and signed a contract. Ali puts % 70 of capital and Veli puts % 30 of capital. Both of them have to manage to company but Ali has more right to decide for business. At the end of the year business had gained 1 Million USD so Ali will take %70 of profit which is equal to 700.000 USD and Veli will have % 30 of profit equal to 300.000 USD. If company had loss again both party will share loss according to their contribution to capital. So no one will have any injustice risk, benefit and loss shared by both of participants. Because of risk, profit and loss shared all participants will work more to gain. On the other hand if interest were put capital owner will have his interest

[66] www.learnislamicfinance.com (05.05.2011)
[67] Aggarval R., Yousef T. (200). Islamic Banks and Investment Financing, Journal of Money, Credit and Financing,p. 32

whatever company loses or benefits. So capital owner do not work hardly to gain because his gain is guaranteed.

2.3.3 Mudarabah

Another type of partnership, called a Mudarabah, forms the basis for equity-financed companies including those trading on the stock market. This partnership is formed between a capital provider, called a rabb-ul-mal in Arabic, and a manager of the business, called a mudarib. Any profits earned in the business are distributed in an agreed-upon proportion between the rabbul- mal and the mudarib. Financial losses, however, are completely borne by the rabb-ul-mal since he or she is the only contributor of capital, assuming the loss is not caused by misconduct on negligence on the part of the mudarib. The mudarib does not bear any financial loss but rather loses the opportunity to earn a living by spending his or her time elsewhere. The rabb-ul-mal does have the option, when forming the contract, to minimize its risk by asking for a guarantee or collateral of an asset from the business. The difference between a mudarabah contract and a musharakah contract with a sleeping partner is that, in musharakah, the sleeping partner has more control than does the rabb-ul-mal in a mudarabah contract. The rabb-ul-mal cannot intervene in the daily management of the partnership or impose restrictions that would paralyze the mudarib's liberty of action. However, the rabb-ul-mal can impose other, less intrusive restrictions in order to control the faithful implementation of the contract.[68]

John has an idea to found business; he applies to an institution which lend money. Institution evaluate John's plan and decide to give him money. They sign a contract, according to contract John will have % 90 of profit and lender will have % 10 of profit. At the end for example business had 1000 USD profit. John will take 900 USD and institution will have 100 USD. IF there is loss john won't have any loss, all loss will be beard by institution. In this case you see there is a partner who does not have any right to manage business. Here institution is the rabb-ul mal and john is the mudarib.

[68] Mavrakis N.(2009). Islamic Finance; a Vehicle for Development. University of Texas, e-book, p. 21

2.3.4 Trade and Sale Financing

Trade is an essential element of any functioning economy. Trade financing can be defined as methods for financing the sale and purchase of goods. Several factors contribute to a sale contract, including rules for a valid sale, a mode of payment, and a price determination method. There are also multiple instruments that can be used to finance a sale. The simplest way is for the buyer to pay cash when he or she obtains the goods from the seller. However, oftentimes more complex financing is needed, such as when the buyer wishes to defer the payment of his or her purchase or when the seller wishes to receive the payment in advance of providing the goods to the consumer. Islamic law specifies two main ways that a price can be determined: musawamah and murabahah. Musawamah is the process of bargaining in which each party agrees upon the price of the good for sale. The seller does not have to reveal his or her cost in this situation. The second method is murabahah, or cost-plus-profit or markup sale, in which the seller reveals his cost to the buyer and the two agree upon a profit margin that they will add to the cost to arrive at a final price. There should be some conditions to validation of sale. First there must be contract verbal or written. The price, good and payment time should be definite. The good must not be unlawful. Payment can be made in cash or by installments. Islam allows extra profit in installments. If these conditions are met, sale is valid according to Islam.

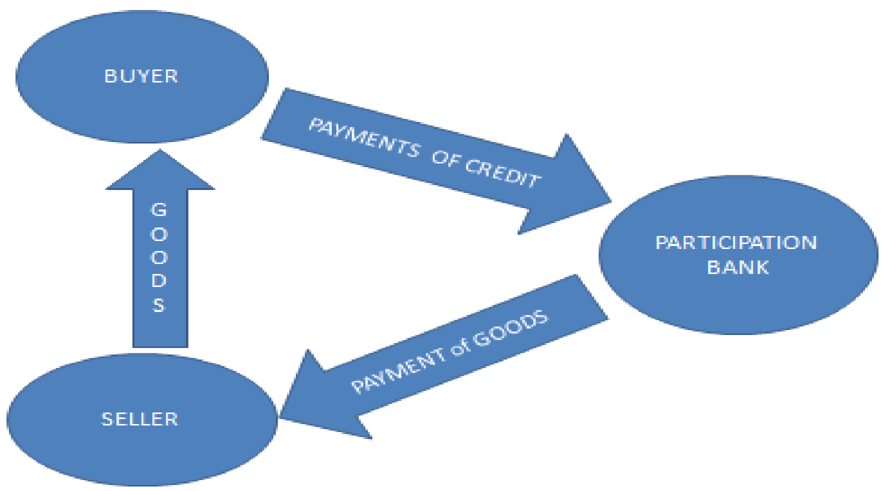
2.3.5 Murabahah

Murabahah is one of the most frequently offered and most frequently demanded financial instruments in Islamic Banking, and means nothing more than a “mark-up sale”[69]. In the literature Murabahah is called either “cost plus financing” or "mark-up sale”[70] When the bank sells the product to the initiator, it is delivered immediately: the redemption normally takes place at a later date, as per the

[69] Kabir H, Lewis M (2007). Handbook of Islamic Banking. Elgar, Cheltenham, p. 174
[70] Bälz K (2005). Islamic Finance: Finanziert mit Gottes Hilfe. Zenith Business 3, p. 35-38

redemption contract. According to Warde (2000), 80-90% of financing of transactions undertaken by Islamic Banks take place in the form of Murabahah, mostly in the industry and trade sectors.[71] In this transaction, the bank bears the risk that the buyer does not take delivery, because at the moment the bank buys the product, it becomes the legitimate owner. If the product is damaged, or the buyer finds some severe quality defect, the bank is liable. If the product does not meet its specification, the buyer has the right to refuse delivery. Therefore the bank acts only after its client has entered a binding commitment to subsequently buy the goods. One aspect of this is often criticized in the literature: banks normally base their mark- up calculations on the LIBOR. [72]

Murabahah works in the following steps first the customer asks seller for the price and agrees on goods to be sold. Then buyer goes to the participation bank and asks bank to buy goods for him. Banks pay money to seller and buyer goes to seller and takes goods. If possible a bank employee goes to see goods to be sure that buyer takes goods not used money for another intentions. After purchase finished buyer pays good fee to bank in installments. Figure below explains Murabahah transaction,



[71] Warde (2000). ibid, p. 133
[72]Usmani M. T (2002). An Introduction to Islamic Finance. Kluwer Law International, London, New York, p. 48

Figure 2

For example Ahmet want to buy a car then firs he goes to car center and select a car, he bargains for car and get agree with seller let's say price of car is 50.000 USD. Then he goes to participation bank and apply for credit but he should give proform bill to bank. Proform proves that Ahmet went car shop and had agreed for that price. Bank pays money to seller. So bank buys car in cash and sells that car to Ahmet in installment. Bank charges installment difference to cost of car. In conclusion Ahmet pays to bank for that car in installment. The difference between private banks operation and participation banks operation is negotiation before credit application. If good is bought before application of credit it cannot be provided credit by participation bank. Because after finish of transaction; profit which is charged, called interest.

Some scholars like Suleyman Uludag criticized Murabahah implementation of participation banks for Sharia rules are skipped by tricks and risk is not shared by both parties. Some other say that profit charged by participation bank is very close to interest rates.

In Islam some applications become halal (legitimate) by proper implementations. Here money is not transacted with buyer and seller directly and pre agreement makes these applications legitimate according to Islam. Charging extra value to goods for time is legitimate in Islam. Islam accepts time value of money. Second there is rough competition between banks if participation banks charges too more profit than interest rate nobody comes to participation banks to get credit. Transactions and applications must be convenient to market realities.

2.3.6 Bay-al Salam

A bay' al-salam contract is a sale with deferred delivery. It is similar to a conventional forward contract, but key differences exist. In a conventional forward contract, two parties agree to buy or sell an asset at a specified time in the future. The payment on a forward contract is not due until the buyer officially gains control of the asset. In a bay' al-salam contract, two parties agree to buy or sell an asset in the future, but the payment is due at the time of the contract, not at the time of the exchange of control. In this way, the seller gains the cash needed to invest in production of this asset and the buyer eliminates the uncertainty of the future price. During the time of the Prophet, the use of bay' al-salam contracts was common among farmers who could not afford to buy seed and raw materials beforehand. However, the permissibility of this type of sale was an exception to the general rule that normally prohibits forward sales. Therefore, the several conditions must be followed when using bay' al-salam contracts. First, bay' al-salam can only be used for products whose quality and quantity can be fully specified at the time the contract is made. Second, full payment of the purchase price is due at the time the contract is made. Third, the exact date and place of delivery must be specified in the contract. Finally, the buyer may take collateral to guarantee that the seller performs his or her obligation.[73]

For example farmer Smith needs capital for seeds, fuel, fertilizer or other materials to farm his land. He borrows money from local traders who is interested in Smith's nutrients. Smith borrows 10.000 USD. 2000 USD is profit of Smith from farming. Smith pays his debt by his nutrients at harvest time. Here quality, amount and price of nutrients must be arranged in agreement.

[73] Mavrakis N.(2009). Islamic Finance; a Vehicle for Development. University of Texas, e-book, p. 24

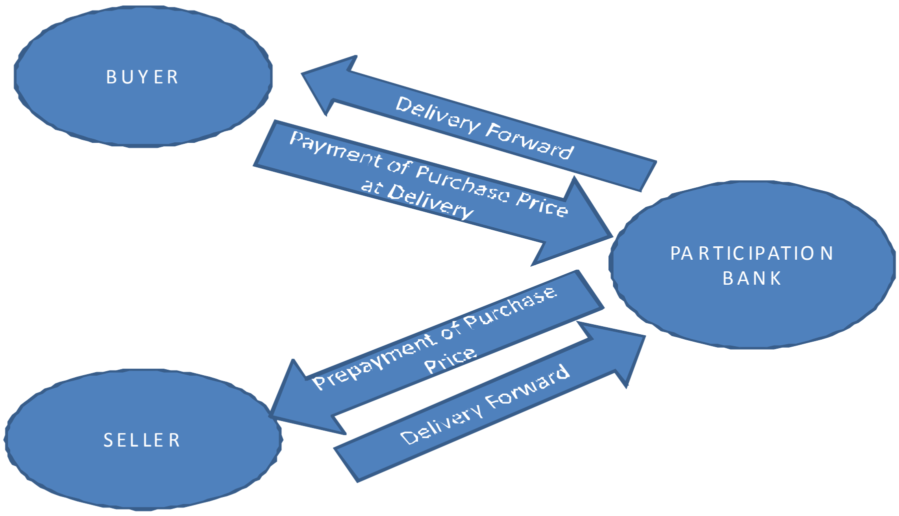


Figure 3

2.3.7 Istisna

An istisna contract is a sale in which the customer asks the seller to manufacture a specific product for purchase. Both parties agree on a price and specifications for the product to be manufactured. If the product does not meet those specifications when it is delivered to the customer, he or she may retract the contract. The two parties have flexibility when deciding payment timing and mode: the price can be paid in a lump sum at the time of the contract, in a lump sum in the future, or over installments. This mode of financing is usually used for aircraft manufacture, equipment installation at factories, construction… Istisna and bay' al-salam are both exceptions to the general rule for sale contracts that the subject of the sale must exist at the time of the sale, described above. However, four differences between istisna and bay' al-salam contracts exist. First, the purchased good in an istisna contract must be manufactured, while it does not have to be in a bay' al-salam contract. Also, buyers in istisna contracts are not required to pay the full price immediately upon signing the contract, as they are in bay' al-salam contracts. Additionally, an *istisna* contract can be canceled by either side before the seller begins manufacturing, while a *bay'* al-salam contract can only be canceled with the consent of both parties. Finally, the seller is given flexibility regarding time of delivery in an istisna contract, while time of delivery must be specified exactly in a bay' al-salam contract.

THY (Turkish Airlines) wants to buy aircrafts from Airbus. Airbus has no premade aircraft. THY and Airbus signs an istisna contract. Airbus make aircrafts and THY pays price of aircrafts after satisfying quality of aircrafts.

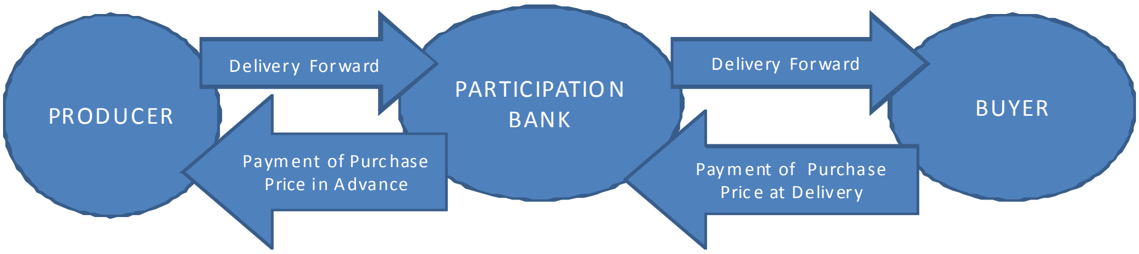


Figure 4

2.3.8 Ijarah

Ijarah, or lease, is the sale of the right to use an object for a specified period of time. Two types of leases exist in Islamic finance: ijarah, an operating lease, and ijarah wa-qtina, a finance or capital lease. ijarah is an Islamic operating lease in which the lease is for a specified short-term period that is shorter than the useful life of the asset. A major advantage of ijarah is that it resembles a conventional operating lease contract. However, certain differences do exist. One difference is that the lessor, as the owner of the asset, bears all risks and responsibilities. Thus, any manufacturing defects of the asset or later damages beyond the control of the lessee are the responsibility of the lessor, though the lessee is responsible for day-to-day upkeep of the asset. Additionally, the lessor may not charge any interest in the event of default or delay in payments. Ijarah waqtina is a finance or capital lease in which the lessor promises to sell the leased asset to the lessee at the end of the lease term. The price for the residual value of the asset is pre-determined. Some scholars argue that finance leases are not permissible due to the non-cancellable nature of the lease contracts that shift the entire risk to the lessee. However, other scholars counter that financial leases are permissible as long as the lessor continues to bear risks of leasing by being the real owner of the leased asset.

2.3.9 Qard-e-Hasna

Qard-e-hasna, or a gratuitous loan, is a loan lent to someone who is in need of fundsand where the lender does not expect any rate of return on the principal. While the borrower is obliged to return the principal, the lender is urged not to pressure the borrower if he or she is unable to repay by the specified deadline. This form of lending is encouraged in Islam as an act of charity. In fact, this is the only true form of a loan that is allowed. Qard-e-hasna literally means “good loan” or “beautiful loan,” which emphasizes that the loan, or qard, is made gratuitously.[74]

Applications of participation banks are explained above. Other applications such as letter of guarantee, money order, cheque providing etc. are not different from

[74] Mavrakis N.(2009). Islamic Finance; a Vehicle for Development. University of Texas, e-book, p. 31

private banks. Those activities are not interest included services. They are banking services people pay money and get banking service.

Some academicians criticize some participation banking activities are very similar to private applications. Resemble of participation applications is normal because needs of people are similar. Target of Islamic banks is providing service to needs of people. Need is capital but implementation is different. Risk is shared by bank and borrower the key point of Islamic rule is this. If bank get loss also depositors will have loss. Why participation banks do not have loss and always paying profit to its depositors? Because of expertism of banks on credit market. They have losses but they are compensating their losses from other projects. They are losing at %10 projects, getting profit from %90 of its projects so similar to other continuing firms banks are earning money and paying to its depositors.

2.4 Islamic Banking in the World

Today, there are more than 430 Islamic banks and financial institutions spread across 75-plus countries and about 191 conventional banks have Islamic windows. Islamic Banking, which is currently concentrated in the Middle East, North Africa, and South-East Asia, is spreading its wings to sub-Saharan Africa, Central Asia, and Western Europe. More than 70 percent of the Islamic banks are in the Middle East, 14 percent in South-East Asia, and 15 percent in sub-Saharan Africa. Assets held by Islamic banks or through Islamic banking windows of conventional banks rose by 28.6 percent to $822 billion in 2009 from $639 billion in 2008, according to a survey of Top 500 Islamic Financial Institutions by The Banker in July 2010.[75] The Lim Hng Kiang, Minister for Trade and Industry of Singapore said that'' Islamic finance is poised to play a bigger and more central role in global finance'' Especially after global crisis in 2008 islamic banks became more powerful than private banks. Islamic banks did not hurt very much from financial crisis because Islamic banks are engaged with real economy, they have not financial bubbles.

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[75] http://www.ftkmc.com

The top Islamic financial institutions in 2007 are defined in table below.

Table 1

Rank	Institution	Country	Asset	Profit
1	Bank Melli	Iran	48,5	542,1
2	Al Rajhi Bank	Saudi Arabia	44	801,1
3	Kuwait Finance House	Kuwait	38,2	633,1
4	Bank Saderat	Iran	32,6	228
5	Bank Mellat	Iran	32,5	162,2
6	Bank Tejarat	Iran	26,3	0
7	Bank Sepah	Iran	24,1	28,8
8	Dubai Islamic Bank	UAE	23,1	471
9	Bank Keshavarzi	Iran	16,3	0
10	HSBC Amanah	UK	15,2	N/A

*Source: The Banker, Supplement on the Top 500 Islamic Financial Institutions

2.4.1 Islamic Banking in Malaysia

Islamic banking in Malaysia differs from Islamic banking in the Gulf and the rest of the world. The country’s first Islamic bank, Bank Islam Malaysia Berhad (BIMB), was established in July 1983. A decade later, the government introduced the Interest Free Banking Scheme, which made Malaysia among the first to have a full-fledged Islamic system operating side-by side with the conventional banking system. Under this framework, conventional banking institutions were allowed to provide Islamic banking services within their existing banking establishment known as the Islamic Banking Scheme (IBS). From only three banks offering Islamic financing in March 1993, the number of conventional banks that offered Islamic financing has increased to 15, of which 4 are foreign banks Today, the Malaysian Islamic banking system is becoming an effective means of financial intermediation reflected by its extensive distribution networks comprising 152 full-fledged Islamic banking branches and more than 2,000 Islamic banking counters. The ability of the Islamic banking institutions to arrange and offer products with attractive and innovative features at prices that are competitive with conventional products, has appealed to both the Muslim and non-Muslim customers. This has spurred the efforts by other non-bank financial institutions such as the development financial institutions, savings institutions and housing credit institutions to introduce Islamic banking schemes and instruments to meet their customer demands. The development of infrastructure institutions to support the Islamic finance industry began in the 1990s. This development was an outgrowth of the difficulties Islamic banks faced trying to operate in a conventional banking system. As of 2009, as stated above, the industry boasts assets of over $600 billion and is growing by 10-15 percent per year. Now more than 300 institutions operating in an estimated 65 countries engage in some form of Islamic finance.[76]

Throughout the years, Islamic banking in Malaysia has gained significance, and has been on a progressive upward trend. Since 2000, the Islamic banking industry has been growing at an average rate of 19 percent per annum in terms of assets against the global growth rate of 15 percent (Rosly, 2005). As at end of 2005, total assets of the Islamic banking sector has increased to RM 111.8 billion, which accounted for 11.7 percent of the banking system's total assets, while the market share of Islamic deposits and financing has increased to 11.7 percent and 12.1 percent of total banking sector deposits and financing respectively and is set to command a 20 percent market share by the year 2010 (Rosly, 2005). This increase was important because Islamic banks have gained to effect Malaysian economy, before 2000's Islamic banks were only a small player in the economy.

[76] Sufian F.(2006).Size and Returns to Scale of the Islamic Banking Industry in Malaysia: Foreign versus Domestic Banks. IIUM Journal of Economics and Management 14, p. 147-175

Banking sector institutions in Malaysia in November 2009

Table 2

Financial Institution	Total	Malaysian Controlled Institution	Foreign Controlled Institution
Commercial Banks	22	9	13
Islamic Banks	17	11	6
International Islamic Banks	2	-	2
Investment Banks	15	15	-
Insurers	40	25	15
Islamic Insurers (Tekaful)	8	8	-
International Islamic Insurers	1	-	1
Reinsurers	7	3	4
Islamic Reinsurers	4	1	3
Development Financial Institutions	13	13	-

*Source: Malaysian Industrial Development Authority (MIDA)

We see that there are very close number of Islamic banks to private banks in Malaysia. Islamic banks applications are quite developed in Malaysia because of other Islamic financial instruments such as tekaful, Islamic reinsurers exist there.

2.4.2 Islamic Banking in Pakistan

Pakistan is one of three nations in the world where the entire financial system is based on Islamic principles (Iran and Sudan being the other two nations). Pakistan was the first country to follow this model. In 1979, it declared full Islamization of its economy and financial institutions when its president declared that the payment and charging of interest would be eliminated within three years despite the president's determination, Pakistan's road to an interest-free system was slow. Among the challenges it faced were poverty among its people, national indebtedness to other nations and organizations, and Western financial habits that were not easily changed due to the entrenchment of the British legacy. In 1985, interest was finally phased out In the early 2000s, the Pakistan government decided to allow both Islamic banks and only the Islamic divisions of conventional banks to operate in Pakistan. It has also promoted the use of more profit and loss sharing techniques Because of these changes; Pakistan's Islamic banking industry has been successful, with assets growing to 20 times their original values between 2004 and 2009. In January 2009, Pakistan's Islamic banks and Islamic divisions of conventional banks planned to open 230 new branches in 2009 as a result of increased demand for Shariah-compliant products. As of January 2009, six Islamic banks and 12 conventional banks with Islamic banking divisions are operating in Pakistan.[77]

2.4.3 Islamic Banking in Iran

In Iran, after the revolution of 1979 the banking system was nationalized. After nationalization, in 1983 the law of usury-free banking was passed. On March 1984 interest free banks started to implement Islamic banking based on the law which legislated in1983.

People were initially hesitant to make investment deposits, but gradually the volume of term investment deposits increased. IN 1990 -91 these deposits were 6,6 times more than in 1983-84. The growth of long-term investments deposits exceeded the short term investment.

Because of Iran is governed by Islamic rules Islamic banking giants located in Iran. The biggest Islamic bank named Bank Melli is in Iran. Also 6 of the biggest 10 Islamic banks located in Iran.

[77] Mavrakis N. (2009). Islamic Finance; a Vehicle for Development. University of Texas, e-book, p. 15

There is oligarchic administration in Iran so free market economy is limited private firms should behave accordance with the government otherwise they cannot live long. Also the war between Iraq and ıran between 1980-1990 effected economy in Iran. Iran suffered war and its economic development slowed after war. Today the biggest Islamic banks according to assets exist in Iran Islamic Republic.

2.4.4 Islamic Banking in Non-Islamic Countries

Islamic banking applications are implemented in some non-Islamic countries. There are some reasons for it, first there are a lot of Muslims who live in western non-Islamic countries. Second risk sharing is model is preferred by non-Muslims also. The banking giants such as HSBC, Citibank and Barclays have Islamic banking departments; they try to lure Islamic banking customers. Especially HSBC Amanah which is Islamic banking department of HSBC is a good example and an important player in the Islamic banking sector. HSBC is England originated bank, England had a lot of Islamic colony, and continuing it relationships with ex-colonies. HSBC Amanah grew because of its historical background. Other countries like Germany, Switzerland and Luxemburg also has vital Islamic banking applications. Muslim population chart in Western Europe listed below;

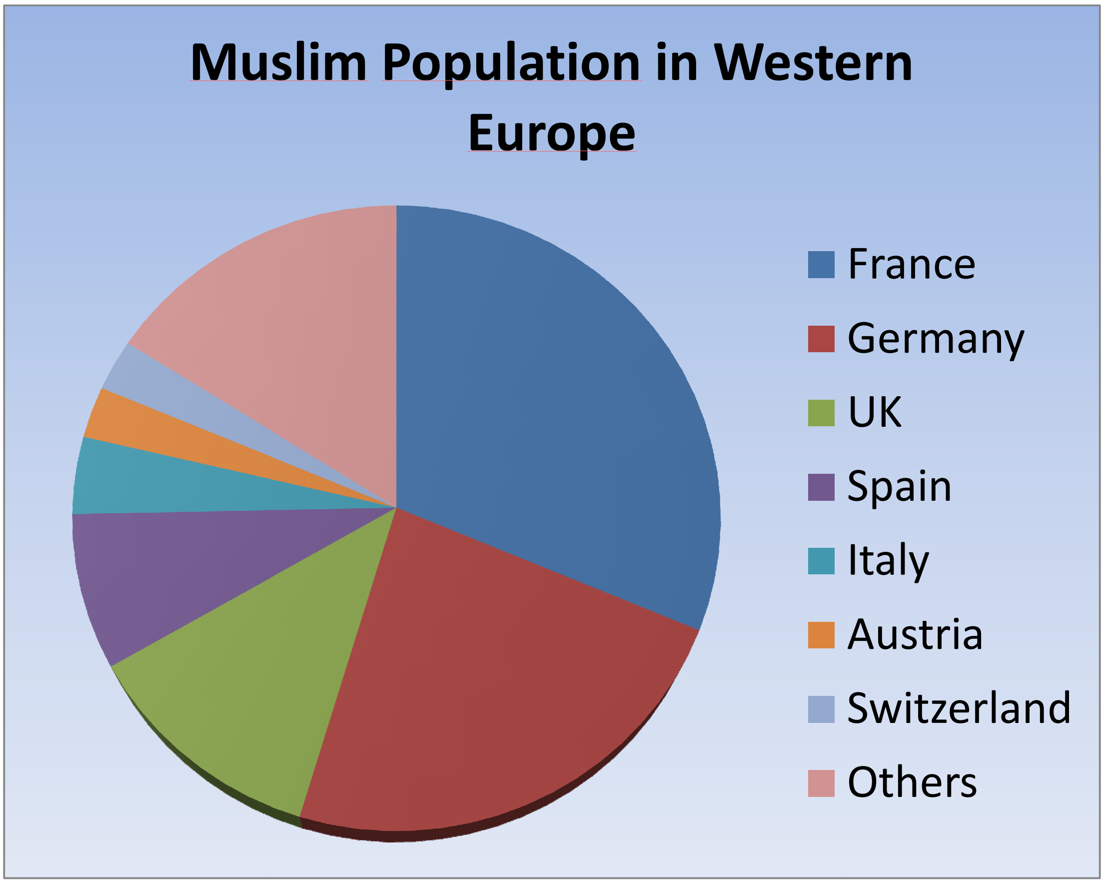

FIGURE 5

There are about 15 million Muslim living in western European countries. France has 4, 7 million Muslim population. Germany is the second having 3,5 million Muslim population. UK has 1,8 million Muslim populations. Three European Union members have 10 million Muslim citizens so three countries have more population than some Islamic countries. Muslim people desire non interest banking applications normally. So some banks found Islamic banking departments to meet Muslim people's needs. They have 'Shariah Council' to control whether applications are appropriate to Islamic rules. It is arguable that banks have interest deposits, interest and non-interest money are mixed. This application should be debated. Islam allows pure interest-free transactions.

Germany as a country with a huge Muslim population, situated in the centre of Europe, is predestined to play an important role in global Islamic finance. It is an important business and trading partner of the GCC (Gulf Cooperation Council) region and one of the major economies worldwide. Despite this preferred position, Islamic banking and finance is more or less non-existent on the German market apart from some transactions in the real estate sector. Only in November 2008 the first Islamic finance conference was organized in Germany. Switzerland is by any measure a country with a high reputation in global financial markets. International prestige and excellent business contacts are among the reasons for Switzerland's attraction in the financial world. Due to its neutrality, Switzerland is even preferred by Arabic capital to financial markets like London.150 Most of the summit conferences and meetings held on the topic of Islamic finance in Europe take place in London, Geneva or Zurich. Various banks offer Islamic products in Switzerland. It should be emphasized that Arabic banks are not automatically Islamic banks too. Several Arabic banks run agencies or offices in western countries that may not operate in a Sharia compliant way. These Arabic banks may offer Islamic products in “Islamic windows”, as many conventional western banks do in both Islamic and non-Islamic countries. If they do not offer such products, the bank must be considered to be a conventional bank.

Citi Islamic Investment Bank (CIIB), established in 1996 in Bahrain, is a 100 percent subsidiary company of Citigroup. The CIIB offers three investment funds: the first is the Citi Private Investment Mudarabah (CPIM), which invests in short-term Islamic products in OECD countries based on low risk commodity Murabahah contracts. The second fund is Citi Emerging Market Mudarabah (CEMM), which invests in emerging markets on the basis of Mudarabah or Ijarah transactions. Last but not least is the Citi Islamic Portfolio, which is subdivided into Global Equity A and Global Equity B (both launched in 1997), both actively managed and open ended.[78] Citibank’s Islamic departments have totally 12,452,000 USD and income is

[78] www.citiislamic.com

960,000 USD in 30th September according to Citibank financial table.[79] Citibanks has its own Sharia Board and Sharia certificate to make Islamic banking.

In 1982 the Royal House of Saudi Arabia encouraged the establishment of Shari'A Investment Services SA, later named Faisal Private Bank (Switzerland) SA, in Geneva. The bank was re-named in honour of the late Saudi king Faisal ibn Abd al- Aziz. In October 2006, it was registered with the SFBC (Swiss Federal Banking Commission) and became a bank under Swiss law. It was the first Swiss bank to operate completely in compliance with the Sharia. Its Sharia Board is consistent with the Sharia Board that is in charge of the Dow Jones Islamic Index. Its main stockholder is the Ithmaar Bank B.S.C., a major manager and provider of Islamic investment products in the Middle East. With its headquarters in Bahrain, Ithmaar Bank B.S.C. holds 79 percent of Faisal Bank SA. Faisal Bank's main aim is to provide products in the wealth management and private investment sectors for its clients. It offers nearly the full range of Islamic financial structures – Mudarabah, Musharakah, Ijarah, Sukuk etc.[80]

UBS AG is a Swiss Bank with subsidiaries all over the world. It operates in the wealth management, investment banking and asset management sectors, and has a long history of active involvement in Islamic Banking. Noriba Bank, a 100 percent subsidiary, was established in the kingdom of Bahrain in 2002. This subsidiary has offered Islamic bonds, private equity, real estate projects, Murabahah contracts and many other Sharia compliant products. Because of increasing demand for Islamic products, Noriba Bank was integrated into UBS in 2006 as a part of the restructuring of the UBS business units. Today UBS provides a wide range of Islamic products. In the asset management sector UBS offers a fund, issued by Noriba in Luxemburg in 2000, and called UBS (Lux) Islamic Fund - Global Equities (formerly the Noriba Global Equity Fund). This is an open-ended fund that invests in companies around the globe that are Sharia compliant and are part of the Dow Jones Islamic Market 100 Titan IndexSM. The individual companies are weighted within the fund according to

[79] www.citibank.com/ciib/homepage/aboutus/ciib_sep_2010.pdf
[80] www.faisalfinance.com (04.03.2011)

their strategic orientation, market position, management, profitability, growth potential, and improvement of shareholder value. The fund attracts mainly investors who are looking for long-term value enhancement and broad investment diversification. In the commodity sector, UBS offers two different types of structures: bespoke indices, and commodity-linked investment certificates. An example of a bespoke index is the UBS Oilfield Strategy Index, which invests in oil allocations for future exploitation. It is a long-term product, unlike conventional oil contracts that are geared to short-term contracts, and is therefore highly volatile. The goal of the index is to replicate a physical oilfield. Commodity-linked investment certificates give the investor the ability to choose freely between different levels of participation and protection, between a wide range of commodities, and between different maturities. The interest yielded by the underlying asset is retained; therefore the product is still Sharia compliant.[81] Armen Papazian who is the director of the UBS Islamic banking department, said UBS seek new profit opportunities in Islamic banking and will try to empower Islamic banking department in 2009.[82] Further products offered by UBS are different forms of Sukuk – for example, Musharakah Sukuk, Ijarah Sukuk and Murabahah Sukuk. All these products are designed for both private and institutional investors. The Islamic Banking sector is becoming more and more important to UBS.

Credit Suisse is a globally active financial services company with its headquarters in Zurich. It offers a wide range of products in the private banking, wealth management and investment banking sectors. Since 2006 Credit Suisse has also provided Islamic financial products. A team has been built up with Islamic financial experts in both Zurich and London. At the moment, the products are aimed mainly at institutional investors, but private customers are expected to be addressed soon. The current fund that Credit Suisse is offering is the CS SICAV One (Lux) Equity Al-Buraq, issued in May 2007 and operated in compliance with Sharia. At

[81] www.ibb.ubs.com/mc/islamicfinance/commodities-linked-investment-certificates.shtml
[82] www.reuters.com

least two thirds of the total capital is invested in shares. If profit is earned that is not compliant with Sharia, it is donated to charity organizations.[83]

Deutsche Bank AG was founded in 1870 in Germany and is today Germany's largest financial institution in terms of total assets. For the last three decades Deutsche Bank AG was active on Arabic markets, with major focus on Islamic Banking and Sharia compliant products. Deutsche Bank was therefore awarded two times special awards: in 2007, the "Most Innovative Custodian Bank – First Islamic Custodian Bank" and "The Biggest and Most Active Custodian Bank for Islamic Funds" in 2008.Deutsche Bank always engaged in cooperation with local banks, like the joint venture with Abraaj Capital of Dubai and Ithmaar Bank of Bahrain for the launch of a financial fund that is run according to the rules of the Sharia. Until 2008, the Islamic Finance Team of the Deutsche Bank was situated in London,but moved in August to Dubai. Part of Deutsche Bank`s Asset Management Division is DWS, a global mutual fund company, with 269 000 billion Euro assets under management. A range of Sharia compliant funds is offered by the DWS in Africa and the Middle East. On the German market Deutsche Bank AG offers a special concept to the Turkish community, called 'Bankamiz (Our Bank) '. In 55 subsidiaries all over Germany financial services are supplied to Turkish people in their mother language. The focal point is laid on cultural differences regarding the language and the distribution channel. Even though this concept targets Muslims on the German market, Bankamiz cannot be seen as part of Islamic finance, but belongs to the group of ethno-marketing (segmentation of a market according to cultural criteria). After all, Deutsche Bank AG does not provide any financial services compliant with the Sharia on the German market.[84]

HSBC Amanah is the global Islamic financial services division of the HSBC Group. Amanah means that, trust, with associated meanings of trustworthiness, faithfulness and honesty Established in 1998, with more than 300 professionals serving the Middle East, Asia-Pacific, Europe and the Americas, HSBC Amanah

[83] www.creditsuisse.com
[84] Aichbichler E.(2009), İslamic Finance in Switzerland and Germany, Vienna, p. 67

represents the largest Islamic financial services team of any international bank. HSBC Amanah exist several countries like Saudi Arabia, Bahrain, Qatar, Brunei, Malaysia etc. HSBC Amanah operations are closely supervised by four Regional Shariah Committees (RSCs) in addition to a Central Shariah Committee (CSC). The CSC supervises HSBC Amanah businesses as well as operations in UAE, Qatar, Bahrain, Bangladesh, Mauritius, US and UK. HSBC Amanah has the largest asset which is originated in non-Islamic country.

Islamic Banking in western countries or western originated banks makes Islamic banking because there are Muslims living there and Muslims demand for Islamic banking. Banks whose main target is correspond needs and getting profit make Islamic banking too. Their main aim is getting profit. World economy has been suffering deep economic crisis since 2008. A lot of people who invested in private banks got huge losses. The most significant reason of the crisis is the investing economic bubbles. In private banking bubbles can be invested, if bubble blast economy collapse and restoration of economy needs time. Islamic banking does not contain economic risks which arises by investing non-existent economic resources. Islamic banks have close relationship with real economy. Some people who is not Muslim but do not want to invest risky economic portfolios also desire work with Islamic banks. So after economic crisis popularity of Islamic banking increased.

2.5 Participation Banking in Turkey

In 1980 Turkey abandoned import substitution development policy and start to implement free market economy. After 1980 Istanbul Stock Exchange and Capital Markets Board of Turkey (SPK) found to deepen Turkish capital markets. First Turkish participation bank established in 1984 and start to operate in 1985 named Albaraka Turk. Albaraka group is a huge financial group which is Saudi Arabia originated. Those days there were no participation bank so people who do not use interest had not any choose so most of them were hiding their savings under the pillow. Turkish economy was suffering that some of the savings cannot be transferred to investment.

There are 3 Banking types in Turkey.

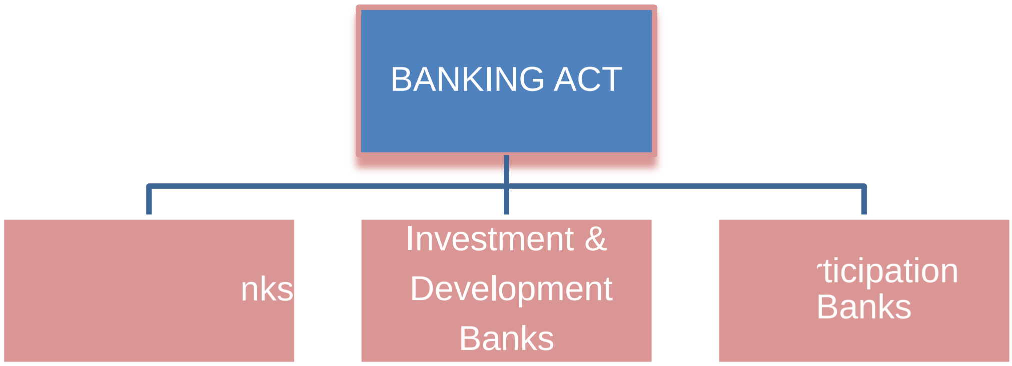

FIGURE 6

Participation Banks have Special Current Accounts and Profit and Loss Participation Accounts for funds. Special current account deposits which is used for money order or putting money to bank. Participation banks make credit applications based on profit-loss sharing. Participation banks also make financial leasing, corporate finance and participation in business projects.

After the start in 1985 with AlbarakaTurk, the Turkish participation banks (before 2005 called Special Finance Houses) were poised to aim at the Turkish market as a whole. Therefore they did not really target the small niche of the "convinced" Muslim population in particular. This of course influenced marketing and product development. Partly as a consequence of this strategy, the Turkish participation banks were able to flourish, and now they hold roughly 6 % of total assets in the country's banking industry. It has outperformed its conventional counterpart for eight consecutive years now. The collapse of Ihlas Finance House (2001 – alleged fraudulent insolvency) meant the loss of 40 % of the deposits held by the sector at that time and the subsequent stampede on the other Special Finance Houses (now participation banks) meant another 35 % loss. Because of their ties to the "real economy", the Participation Banks were not hit by the big financial crisis that hit Turkey in 2001 and they recovered fast. Their deposits now have been taken into the guarantee fund of the banks up to 50.000 TL (to avoid other shock withdrawals) and the sector has acquired bank status. Other differences to note: There is no specific government aid to the sector and nor is there (government or corporate) Islamic bond, although the issuance of a government sukuk could be in the making, one of the participation bank called KuveyTurk issued first sukuk bonds in 2010 . The talks on the projected rent (Ijarah) certificate are progressing slowly, due to inactive local financial markets, cheap conventional international funding and political factors.

There are 4 participation bank in Turkey named Albaraka, KuveytTurk, Bank Asya and Turkiye Finans. In spite of being last entered bank into sector Bank Asya is the largest player in Turkey. Bank Asya has the largest deposits and assets. Anadolu Finance and Family Finance merged and become Turkiye Finans in 2005. Turkey Finance became the largest participation bank in Turkey. Three of participation bank is backed by holdings- group of companies-. Turkey finance is owned by two giant holdings named Ulker and Boydak. Ulker is famous for chocolate and food sector. Ulker bought famous Belgian chocolate firm Godiva in 2009. Boydak is originated from an Anatolian city Kayseri and produces furniture. Boydak group is the largest furniture producer in Turkey. Albaraka Turk and KuveytTurk is owned by foreign capital. AlbarakaTurk was founded by Albaraka banking Group (ABG), one of the prominent groups of the Middle East, Islamic Development Bank (IDB) and a native industrial group of Turkey, which served the Turkish economy for more than half a century. As of 31 August 2010, the share of the foreign partners is 66,16%, the share of the native partners is 11,61% and the share open to public is 22,45% in the partnership structure of Albaraka Turk.[85] Shareholders of Kuveyt Türk are Kuveyt Finance House (62%), Kuveyt Social Security Institution (9%), Islamic Development Bank (9%), General Directorate of Associations Turkey (18%), and other shareholders (2%). The Kuveyt Finance House, which is the largest shareholder of Kuveyt Türk with its 62 % share, is a giant finance institution of Kuveyt with its outstanding asset volume and contemporary and pioneering banking services.[86] Collapse of Ihlas Finance decreased trust to participation banks but they came together and found an insurance fund to finance bankrupted banks. The largest participation Bank in Turkey named BankAsya is not owned by one company or one person. The company's name, which had been previously "Asya Finans Kurumu Anonim Şirketi", was changed into "Asya Katılım Bankası Anonim Şirketi" on December 20th, 2005. (all participation banks name had changed because of law) Bank Asya, initial capital of which is 2 million TL and current paid up capital is 900 million TL, has a multi-partnered structure based on domestic capital consisting of 244 shareholders except for the publicly held part as of the end of 2008.[87]

Some financial data about participation banks listed below. (2010),

Table 3

Name	Founding Year	Total Asset(TL)	Total Branch	Total Employee
Albaraka	1985	7.672.131.000	109	2175
KuveyTurk	1989	8.644.183.000	141	2850
Bankasya	1996	13.240.529.000	175	4275
Turkiye Finans	2005	9.953.301.000	182	3403
Total	-	39.510.144.000	607	12703

*Source: Turkey Participaton Bank Union (www.tkbb.org.tr) September 2010

85 www.albarakaturk.com.tr
86 www.kuveytturk.com.tr
87 www.bankasya.com.tr

There are some advantages of Islamic finance in Turkey such as accordance with Islam, sharing risk with customer, minimum cost. There are some people who do not evaluate his money with interest. They are natural customer of Islamic banks. Both sides gaining in this transaction customer can invest his money in bank so he can revalue his money against inflation and bank gain from real projects. Islamic banks sher risk with its customers because iti is profit loss sharing contract so bank do not have to pay excess value whether it has loss in project. Customer and bank is at the same ship so both parties understand each other, their aim is same. However in interest one party will gain whatever business gain or lose so lender do not mind the other party only one of the party’s aim is getting profit from business. Theoretically Islamic banks have less cost than private banks because he does not have to pay to its lenders’ but in real Islamic banks cost is more than private banks. Private banks can gain from financial products which includes interest but Islamic banks cannot gain from interest included financial products however they compete in the same market so private banks may sell their products or lend money with lees cost. Additionally private banks control % 94 in Turkish market so they can benefit from economies of scale. Islamic banks can service to its customers with less cost when they control quite large amount of the market.

Participation banks have some disadvantages in Turkish market such as, using few financial instruments, inadequacy of corresponding quick needs, not entering to public finance. Participation banks cannot buy or sell some financial instrument which includes interest like bond, repo, insurance...customers want to work banks who can make all financial transactions so participation banks cannot address some part of the customers. Second participation banks cannot fund ongoing projects. Businessman sometimes need money when project is continuing if participation bank fund that project, transaction will include interest so transaction will not be accordant to Islam. Participation banks can fund before project starts so their ability to corresponding needs will be limited. States lend or borrow money with interest today so participation banks cannot enter to public financial papers. Especially in third world countries like Turkey public bonds always get more than inflation rate and risk of public debt is zero because state can issue money. Private Banks lend to state they get profit without risk and they compete with participation bank in the same market. This situation could be called unrightfully competition but it occurs every day.[88]

Nevertheless, Islamic banking in Turkey has been thriving almost in adversity - not only having to cope with structural problems such as a serious mismatch between short-term deposits and money and longer term maturities-; the volatility of the Turkish lira, in which even some Turks relished to speculate when appropriate especially in a high interest-rate environment (this impacted on the SFHs which operate on an interest-free profit-and-loss banking basis); and the general state of the Turkish economy.

The Turkish Islamic bankers argue that their reserves with the central bank and other such contingencies could also be invested in such Sukuk, not only creating more liquidity but also opening up Islamic acceptable investment avenues for such tied capital. Turkey of course already accesses millions of dollars of Islamic finance from the international markets on a regular basis. HSBC, Citibank, and other banks regularly arrange Islamic finance syndications for Turkish corporations and entities. The expansion of the international terminal of Ataturk International Airport is being financed by a syndicated Murabahah facility arranged by HSBC. The Islamic Development Bank together with HSBC also recently lead managed a $100 million Murabaha facility for Turkcell, -the Turkish mobile phone operator- in 2004.

As such, the government decreed that all banks must participate in the country's deposit guarantee fund. The government has allowed the Islamic banks to set up a parallel Islamic deposit insurance scheme, which is the same as the conventional counterpart in all but one respect. The Islamic scheme only invests the deposit insurance pool according to Islamic investment principles. The scheme is managed by the Association of Special Finance Houses of Turkey but regulated by the Banking Regulation and Supervision Board. The scheme, introduced in July 2003, is the only Islamic deposit insurance scheme in the world.

[88] Uslu S.(2005). Faizin Yasaklanması ve Çağdaş Finans , İstanbul: Zafer Yayınları, p. 130-134

In Turkey it is debated that how participation banking will be formed in the future. Turkish experience in Islamic banking is different from other countries. There was no legal infrastructure when Islamic banks started to found. First they were called' Special Financial Institution' after 2005 Banking Regulation and Supervision Authority (BDDK) included them into banking sector laws and banks changed their names as participation banks. Before 2000 Islamic banks were servicing only to big firms they did not have private banking instruments because of their Sharia Board's disallowance? After 2000's they start to give credit cars, letter of guarantees, cheques and other private instruments. Islamic Banks' Sharia boards behave more flexible after 2000's. Now debate is ongoing on should participation banks behave more flexible or should they apply Islamic rules roughly. Some academicians criticize Islamic banks about getting more closely to private banks some others like Hayrettin Karaman who is the most trusted academician in theology in turkey defend banks against claims about their applications is not inappropriate to Islam.

Islamic Banking is the first experience about interest-free applications in finance. Islamic Banking gets increasing market share in the world. Especially after deep economic crisis; Islamic Banking examples may be good interest-free financial implementation. For financial transactions to be Shariah compliant there needs to be a credible assurance mechanism. This system of each Islamic financial institution having its own Shariah board has worked well, as in practice the members of the boards have been constructive rather than restrictive, and have been quite willing to approve new types of deposit and finance facilities. Indeed, the system of shariah compliance has become market driven, which has resulted in product differentiation and extended customer choice. Some applications of Islamic banking could be debated but theoretically there is no interest application in Islamic banking nevertheless practically there may be some misapplications which are originated from people. Peoples' mistakes should not be charged to all Islamic banking system.

M. Raquibuz Zaman who has publications about Islamic Banking criticizes mudarabah. He says that'' The mudarabah accounts are popular with the Islamic Banks partly because they assume very limited liability and risk while earning rather hefty margins. As currently practiced, they simply collect "profits" (estimated ahead of time) from the borrowers. Suppose an individual wants to borrow $100,000 for building a single-family home. The Islamic Bank agrees to lend the money at an agreed upon "profit" rate of 12 percent per year. However, the borrower receives a check for only $88,000 and is asked to pay back the full amount of $100,000 at the year-end. This mudaraba account yields the equivalent of 13.64 percent to the bank. If the "profit" rate were named "interest" rate, the borrower would still pay the 13.64 percent effective rate. If the borrower could not pay back the loan because the project failed for whatever reason, it is not clear how the Islamic Banks will treat the loan and the defaulting borrower. Similar problems are faced by depositors and/or subscribers of capital to the Islamic Banks. If the institutions fail to invest their depositors' and shareholders' money judiciously, there is no recourse to recover some of the funds lost. The failure of the Ar-Ryaan investment banking outfit in Egypt devastated the poor Egyptian subscribers, some of whom lost their life's savings.’’[89]

Raquibuz Zaman’s approach is very narrow sighted, it neglects whole picture. First of all in practice system does not work as Zaman’s claim, Islamic Bank does not give to customer debt minus profit. For example Bank lends money 100.000 USD and takes 112.000 USD after buy of house. In private Bank implementation the return on capital is arranged but risk is indefinite. There will be profit or loss no one can know the future. For example a customer borrows money at % 10 interest rate if business gets more than 10% lender will have unfairness, on the other hand if profit is less then 10% borrower has unfairness. In interest risk and return cannot be fair and risk is shouldered by only one party. Islamic Banks does not lend money. They buy house or car and sell them to customer the margin between buying price and selling price is fee of installments. In Islam selling goods by installments is halal (legal) of course there is difference between cash and future cash. By Mudarabah or murabahah customer has either time utility or place utility. The most popular Islamic financial products, notably Murabahah and

[89] M. R. Zaman and H. Movassaghi (2001). Islamic Banking A Performance Analysis, The Journal of Global Business, 12, p. 38

Ijarah, were pioneered and refined in the GCC, and although investment Mudarabah deposits were first developed in Jordan, the concept soon spread to Kuwait, Bahrain, Qatar and the UAE. Funds became the preferred vehicle for those seeking returns on investment. Turkey is also new and important applicator of Islamic Banking. As told above Turkey reorganize its Islamic banking law and changed its name. Turkey is the only country who calls Islamic Banking as Participation Banking. Participation Bank term is correct because origin of Islamic Banking based on Profit-Loss Participation. Turkish Participation Banks' market share also increasing. I think the most important threat for Turkish participation banks is bringing closer their applications to private banks because of customer demands. Shariah Boards have crucial responsibility for this danger. Market forces like getting more profit or more customers should not damage Islamic Banks' mission.

CHAPTER 3

3. KINDS OF FINANCIAL CERTIFICATES

In this chapter 'kinds of financial certificates' such as bonds, treasuries, shares, asset backed securities, revenue sharing bonds and sukuk will be explained. Sukuk is main topic of this study and sukuk is an alternative, interest-free way of financial bonds so financial bonds should be explained before sukuk to be more comprehensible. Features of bonds and treasuries, shares and sukuk will be explained. Financial development in the twentieth century is an important heading because after arise of capitalism in twentieth century financial tools also start to vary, financial tools grew to fulfill capitalist demand. Turkeys financial history will be explained either. At the end of the chapter sukuk will be defined shortly, sukuk will be explained in the next chapter widely.

3.1 Bonds

Bonds are securities that establish a creditor relationship between the purchaser (creditor) and the issuer (debtor). The issuer receives a certain amount of money in return for the bond, and is obligated to repay the principal at the end of the lifetime of the bond (maturity). The difference can be summed up in one phrase: debt versus equity. That is, bonds represent debt, and stocks represent equity ownership. Typically, bonds also require coupon or interest payments. Since all these payments are determined as part of the contracts, bonds are also called fixed income securities. A straight bond is one where the purchaser pays a fixed amount of money to buy the bond. At regular periods, she receives an interest payment, called the *coupon payment*. The final interest payment and the principal are paid at a specific date of maturity. Bonds usually pay a Standard coupon amount, C, at regular intervals and this represents the interest on the bond. At the maturity of the bond, the final interest payment is made plus the principal amount (or paramount) is repaid. Some bonds do not make a coupon payment. These bonds are bought for less than their face value (we say such bonds are bought at a discount). Bonds that do not pay coupons are often called *Zero Coupon Bonds.* There two types of bonds according to issuer first one is treasury bonds second one is corporate bonds. Treasury bonds are issued by governments. Corporate bonds issued by companies, banks or insurance institutions. There are three type of bons; Treasury bonds, Municipality bonds and corporate bonds.

- Set Maturity Dates :Bonds have set maturity dates that can range from one to 30 years — short-term bonds (mature in three years or less), intermediate bonds (mature in three to ten years) and long-term bonds (mature in ten years or more)
- Interest Payments : Bonds typically offer some form of interest payment; however, this depends on their structure: "Fixed Rate Bonds" provide fixed interest payments on a regular schedule for the life of the bond; "Floating Rate Bonds" have variable interest rates that are periodically adjusted; and, "Zero Coupon Bonds" do not pay periodic interest at all, but offer an advantage in that they are can be bought at a discounted price of the face value and can be redeemed at the face value at maturity
- Principal Investment Repayment :Bond issuers are obligated to repay the full principal amount of a bond in a lump sum when the bond reaches maturity
- Credit Ratings: People can evaluate the "default risk" (the risk that the issuers won't be able to make interest or principal payments) of a bond by checking the rating it has been given by a bond rating agency such as Moody's Investors Service or Standard and Poor's. Rating symbols showed below. AAA is the highest rating symbol only the most trusted states or corporate have these ratings like General Electric, Google, USA, and Finland… After global crisis in 2008 rating institutions started to debated by academicians because some institutions like Lehman Brothers has high rating but Lehman Brothers went bankruptcy during financial crisis. For instance Turkey's credit ratings are Ba3 according to Moody's, BB(-) on Standard and Poor's and BB according to Fitch.[90] Turkish economy is not suffered too much from global crisis. Tunisia changed its president by public riot called 'Jasmine

[90] www.ntvmsnbc.com (17.04.2011)

Revolution'. Despite economic activities slowed after revolution Tunisia's credit ratings still higher than Turkey. Credit Rating Institutions have great power. They can route foreign investments. Credit Rating institutions must be more objective and professional because people invest their money looking to credit institutions.

Table 4

	Investment-Quality Bond Ratings				Low-Quality, Speculative, or "Junk" Bond Ratings					
S&P	AAA	AA	A	BBB	BB	B	CCC	CC	C	D
Moody's	Aaa	Aa	A	Baa	Ba	B	Caa	Ca	C	D

- Callable Bonds :If the bond has a "call feature", the issuer is allowed to redeem the bond before its maturity date, repay the loan and thus, stop paying interest on it
- Minimum Investment: Bonds are usually issued in exact money amount like $1,000 or $5,000 denominations.

Bonds include debt interest according to Islam so a Muslim cannot buy or sell bonds. Debt interest is excess value of borrowed money. For example if one buys a bond and indebted 100 USD but took 80 USD, this is debt interest extra 20 USD will be pay. So this type of debt is not valid in Islam or in other religions.

3.2 Treasuries

Treasuries are tools for indebtness of governments. After 1800's governments need to borrow money from public or banker. Arise of capitalism increased use of government bonds. Governments prefer borrow money instead of increasing tax rates because in democracy governments need vote and high tax rate evade voters. People and banks prefers government bonds because there is no credit risk on it. Theoretically states do not bankrupt so all people trust on it. Treasury bond can be used as guarantee on banking transactions. Treasures valued highest guarantee by banks. Treasuries used not only for borrowing but also controlling money supply. Open Market Operations made by treasuries. If central bank (theoretically independent but still argued whether they are independent or not) desires to increase money supply central bank buys treasuries from market so money is injected to market, If central bank desires to decrease money supply bank sells treasuries to market so money is collected from market. After global economic crisis in 2008 especially USA used treasuries for expansionary money policy to create demand. In USA (core of Capitalism) Treasuries include four types of bonds; these are Treasury Bills (T-Bills), Treasury Notes (T-Notes), Treasury Bonds and Treasury Inflation Protected securities.

3.2.1 Treasury Bills (T-Bills)

Treasury bills which are issued up to one year, Treasury bills issued without coupon so state repay only bond value. Regular weekly T-Bills are commonly issued with maturity dates of 28 days (or 4 weeks, about a month), 91 days (or 13 weeks, about 3 months), 182 days (or 26 weeks, about 6 months), and 364 days (or 52 weeks, about 1 year). Treasury bills are sold by single-price auction sheld weekly. Offering amounts for 13-week and 26-week bills are announced each Thursday for auction, on the following Monday and settlement, or issuance, on Thursday. Offering amounts for 4-week bills are announced on Monday for auction the next day, Tuesday, and issuance on Thursday. Offering amounts for 52-week bills are announced every fourth Thursday for auction the next Tuesday, usually at 11:30 am, and issuance on Thursday. Treasury bills are quoted for purchase and sale in the secondary market on an annualized discount percentage, or basis. With the advent of Treasury Direct, individuals can now purchase T-Bills online and have funds withdrawn from and deposited directly to their personal bank account and earn higher interest rates on their savings.[91]

3.2.2 Treasury Notes

Second one is treasury notes whose maturity is between one year and ten years. Treasury notes include coupons so government pays interest to bonds. Treasury notes bring coupon payments twice a year. The 10-year Treasury note has become the security most frequently quoted when discussing the performance of the U.S. government bond market and is used to convey the market's take on longer-term macroeconomic expectations.

3.2.3 Treasury Bonds

Treasury bonds can be issued by any maturity more than ten years. They are straight bonds and pay coupons twice per year, with the principal paid in full at maturity. They have a coupon payment very six months like T-Notes, and are commonly issued with maturity of thirty years. The secondary market is highly liquid, so the yield on the most recent T-Bond offering was commonly used as a proxy for long-term interest rates in general. This role has largely been taken over by the 10-year note, as the size and frequency of long-term bond issues declined significantly in the 1990s and early 2000s. However, because of demand from pension funds and large, long-term institutional investors, along with a need to diversify the Treasury's liabilities - and also because the flatter yield curve meant that the opportunity cost of selling long-dated debt had dropped - the 30-year Treasury bond was re-introduced in February 2006 and is now issued quarterly.[92]

3.2.4 Treasury Inflation-Protected Securities (TIPS)

Treasury Inflation-Protected Securities (or TIPS) are the inflation-indexed bonds issued by the U.S. Treasury. The principal is adjusted to the Consumer Price Index, the commonly used measure of inflation. The coupon rate is constant, but

[91] www.wikipedia.org (10.02.2011)
[92] www.wikipedia.org (10.02.2011)

generates a different amount of interest when multiplied by the inflation-adjusted principal, thus protecting the holder against inflation. TIPS are currently offered in 5-year, 10-year and 30-year maturities.[93]

The relationship between TIPS and the Consumer Price Index affects both the sum you are paid when your TIPS matures and the amount of interest that a TIPS pays you every six months. TIPS pay interest at a fixed rate. Because the rate is applied to the adjusted principal, however, interest payments can vary in amount from one period to the next. If inflation occurs, the interest payment increases. In the event of deflation, the interest payment decreases. At the maturity of TIPS, you receive the adjusted principal or the original principal, whichever is greater. This provision protects you against deflation. TIPS are sold in Treasury Direct and Legacy Treasury Direct, and through banks, brokers, and dealers.[94]

There are some advantages and disadvantage of bonds;

Advantages:

- Investing in debt is safer than investing in equity. The reason for this is the priority that debt holders have over shareholders. If a company goes bankrupt, debt holders are ahead of shareholders in the line to get paid. In a worst-case scenario such as bankruptcy, the creditors usually get at least some of their money back, while shareholders often lose their entire investment.
- The interest rates on bonds are typically greater than the rates paid by banks on savings accounts. As a result, if a person saving and he doesn't need the money in the short term, bonds will give the greatest return without posing too much risk.

Disadvantages:

- Return is not too high. Bond is not risky investment option if risk is law return is law also.

[93] www.treasurydirect.gov
[94] www.treasurydirect.gov

These advantage and disadvantage is not for economy these advantages or disadvantages are according to investors. For the economy bond is not beneficial, because one party is giving capital and waiting for his profit but the other party shoulder all of the risk.

Table below shows USA bonds interest or return rate.

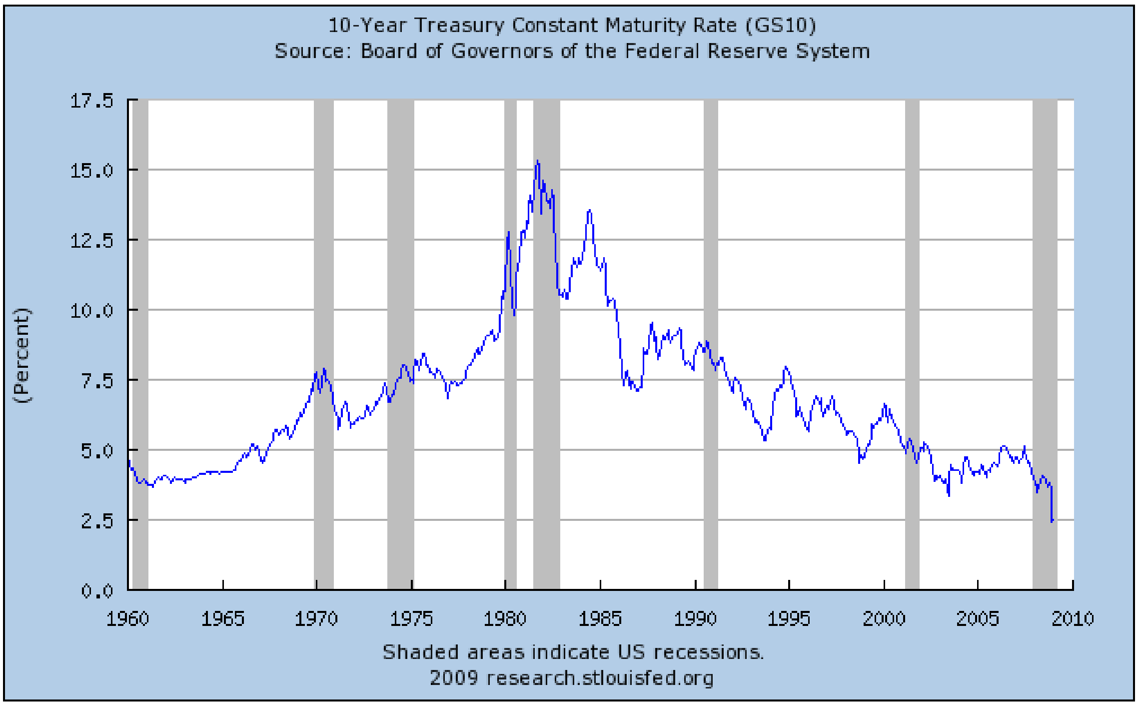

FIGURE 7

3.3 Corporate Bonds

Corporate bonds are financial tools for companies to borrow money from people or banks. Corporate bonds also depict corporates' financial situation. If interest of bond is high it shows that company is not so credible to lend money. The bond market plays a very important role in the financial systems of economies. Bond markets bring lenders and borrowers together. They allow lenders to invest in relatively low risk assets and borrowers to obtain funds in relatively liquid markets. Bond markets are important in determining the prices of other assets, and bank interest rates usually follow market-determined interest rates on bonds. The prices determined in the bond markets affect household decisions to save and the corporate sector's investment decisions. In the United States, the bond market is about the same size as the stock market. In Europe, bonds amount to approximately two-thirds of the total amount of securities outstanding. But the distribution of the total debt differs significantly between Europe and the United States. In Europe, the bond market is dominated by government bonds and bonds issued by financial intermediaries. In the United States, the proportion of bonds issued by the non-financial corporate sector is much larger. In addition, municipal bonds and agency bonds are major components of this market. A market so important should operate well. For the bond market, this means both efficiency and liquidity. Efficient bond prices, incorporating all available information, will be better signals to investors and savers than if the markets did not incorporate relevant information fully into prices. Liquid bond markets bring transactions costs down for investors, who therefore achieve greater gains from trade, and they minimize the cost of funds to firms.[95]

The transparency of the secondary markets for corporate bonds is currently heavily debated. Is the current level of transparency optimal? Or should it be raised? And in this case, will such a change emerge spontaneously from market forces, or is regulatory intervention necessary? There are at least two types of transparency. Markets are ex-ante (or pre-trade) transparent when investors have access to quote information before trading. Ex-post (post-trade) transparency refers to the dissemination of information about trades to market participants. These broad categories themselves must be refined. For example, ex-ante transparency is greater if the observable quotes are firm, or if the identity of the agent posting the quote is known, or if all orders are visible (as opposed to hidden). Also, the greater the population of investors observing ex-ante quotes or ex-post-trades information the greater the level of transparency. Post-trade transparency, is to some extent separable from other aspect of market microstructure. The market can be order- or quote-driven, electronic-, telephone-, or floor-based. It does not really matter. These features of the market, as well as the offers and the negotiations between the traders, and their information sets, are the inputs of the trade. The price and the quantity

[95] Center for Economic Policy Research(2006). European Corporate Bond Markets: Transparency, Liquidity, Efficiency, London,

exchanged are the output. Post-trade transparency relates only to the output, it remains agnostic about the input. In contrast, pre-trade transparency relates directly to the inputs of the trade. Changing the degree of pre-trade transparency would require intervening in the microstructure of the market. For example, consider a purely telephone-based dealer market. It is not clear how such a market would support pre-trade transparency. Important changes to its microstructure would be needed. On the other hand, in an electronic limit-order book, pre-trade transparency would be easy to implement. On the other hand, greater transparency could reduce the supply of liquidity. Once a liquidity supplier has purchased securities, he usually endeavors to resell at least part of the purchase, to manage inventory. If his competitors have observed this initial trade, however, they may be tempted to react opportunistically. Knowing he needs liquidity and is willing to pay for it, they will raise its price. Thus after large trades in transparent markets, liquidity suppliers trying to unwind inventory can be in a weak bargaining position. This will increase the margin they will require from investors to offer liquidity in the first place. Another argument against greater transparency is that it could reduce information acquisition and revelation in the market place. Because transparency reduces the rents earned by informed traders, it reduces the incentives to acquire information.[96]

3.4 Stocks (Shares)

Joint stock Company divides its capital into units of equal denomination. Each unit is called a share. These units are offered for sale to raise capital. This is termed as issuing shares. A person who buys share/shares of the company is called a shareholder, and by acquiring share or shares in the company becomes one of the owners of the company. Thus, a share is an indivisible unit of capital. It expresses the proprietary relationship between the company and the shareholder. The denominated value of a share is its face value: the total capital of a company is divided into number of shares.[97]

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[96] Center for Economic Policy Research (2006). European Corporate Bond Markets: Transparency, Liquidity, Efficiency, London

[97] www.wikipedia.org

According to Stanley Fischer and Robert C. Merton ‘’Economic theory tells us that in a well—functioning and rational stock market, changes in stock prices reflect both revised expectations about future corporate earnings and changes in the discount rate at which these expected earnings are capitalized. Corporate profits are an important part of GNP and are also likely to be positively correlated with other components of CNP. The forward—looking property of stock prices would, therefore, appear to qualify the stock market as a predictor of the business cycle. If, moreover, the information reflected in stock prices is of high quality, then stock prices should provide accurate predictions.’’[98] This explanation tells us that shares and real economy has tight links. Shares and financial bonds are different thing as Fischer and Merton share price could be changed by economic situation so it has same risk factor like other goods but bonds do not have risk factor borrower will pay his debt although company got bankruptcy.

According to Lancaster, the utility of an individual or household is dependent on the characteristics that make up a good. For example, in the consumption of transport, the consumer might derive utility from one of two characteristics, speed and comfort. They may be obtained in different proportions depending on the choice of the form of transport, such as a bicycle and/or a car, It is assumed that households and firms, as buyers of financial products, expect to obtain three characteristics from the purchase of financial goods. These are the expected rate of return E(R), security, and liquidity. The expected rate of return is the mean yield on an asset, plus the forecast gain (loss) net of transactions costs.[99]

Different from bonds stocks represent owning some part of company. So it is not forbidden in Islam sukuk also based on real economic value. Sukuk and shares resembles each other both of them has risk and linked to real economic value. One area of economic transactions has not received due attention in the literature: the question of whether capital gains are lawful, that is, the appreciation of the value of

[98] Fischer S. And Robert Merton(1984). Macroeconomics and Finance: The Role of Stock Markets, NBER Working Paper Series, 12 P. 91
[99] Haffernan Shelagh A.(1990). A Chorarcteristics Definition of Financial Markets, Journal of Banking and Finance 14

an asset which otherwise would earn either no income or variable income subject to market conditions for the period that the asset is held. Clearly, all types of assets such as financial portfolios consisting of stocks, real estate, or even commodities such as gold and wheat fall in this area. The basic premise for obtaining capital gains is that an asset is held for a period in anticipation of an appreciation of its value. This involves some degree of speculation. There seem to be injunctions against speculation in Islam; however it is not clear whether the injunctions apply against all speculative activities, even those that have a stabilizing effect on market prices, or whether they refer to destabilizing speculation which would tend to create shortages in the spot market, and thus higher prices when speculators buy at the spot in rising markets in expectation of even higher prices. Stabilizing speculation, of course, has the effect of increasing supply and thus will reduce prices during rising markets when speculators sell to take advantage of higher prices. In falling markets speculator will buy, thus increasing demand which tends to stabilize falling prices.[100]

3.5 Asset Backed Securities

Asset securitization is the issuance of a debt instrument backed by a revenue-producing asset of the issuing company. Asset securitization involves producing bearer asset-backed securities, which can be freely traded and which are secured by a portfolio of receivables. In order to ensure marketability, the instrument must have general acceptability as a store of value; hence, the security is generally either rated by credit rating agencies, or is guaranteed by an independent guarantor. Further, to ensure liquidity, the instrument is generally prepared in homogenous lots.[101] Theoretically, any asset that has a revenue stream can be transformed into a marketable debt security. In practical terms, the vast majority of ABS is collateralized by loans and other financial assets. Asset Backed Securities can be categorized into Mortgage and Non-Mortgage Securities. Mortgage Securities represent an ownership interest in mortgage loans made by financial institutions (savings and loans, commercial banks, mortgage companies) to finance the

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[100] Noorzoy M. S.(1982). Islamic Laws on Riba (Interest) and Their Economic Implications. International Journal of on Middle East Studies 14, p. 3-17

[101] Akbulak Y.(2005). Varlığa Dayalı Menkul Kıymetler, www.spk.gov.tr (10.05.2011)

borrower’s purchase of a home or other real estate. When these loans are pooled by issuers for sale to investors, mortgage securities are created. As the underlying mortgage loans are paid off by the homeowners, investors receive payments of interest and principal. Non- Mortgage Securities Include new assets such as collateralized bond/loan obligations, non-performing loans, tax liens, small business loans, rental cars and franchises, asset-backed commercial paper, revolving consumer assets (credit cards), synthetic securities, auto loans and leases, home-equity loans, manufactured housing contracts student loans, recreational vehicles, marine loans, commercial equipment and time share.

Sukuk is very similar to Asset Backed Securities. Structure of the sukuk copied from asset backed security structure the only and the most important difference is sukuk does not include interest. We can say that sukuk is the ‘interest-free’ Asset Backed Security. ‘Special Purpose Vehicle’ term come from asset backed security. Term is first used USA and conveyed to Islamic financial tool named sukuk. SPV (Special Purpose Vehicle) term is not suitable for sukuk we will explain why it is not suitable and what term should be used instead of SPV in next chapter.

Because of high interest rates and no-existence of second market mortgage market could not grow in Turkey.

Structure of Asset Backed Security Shaped Below:

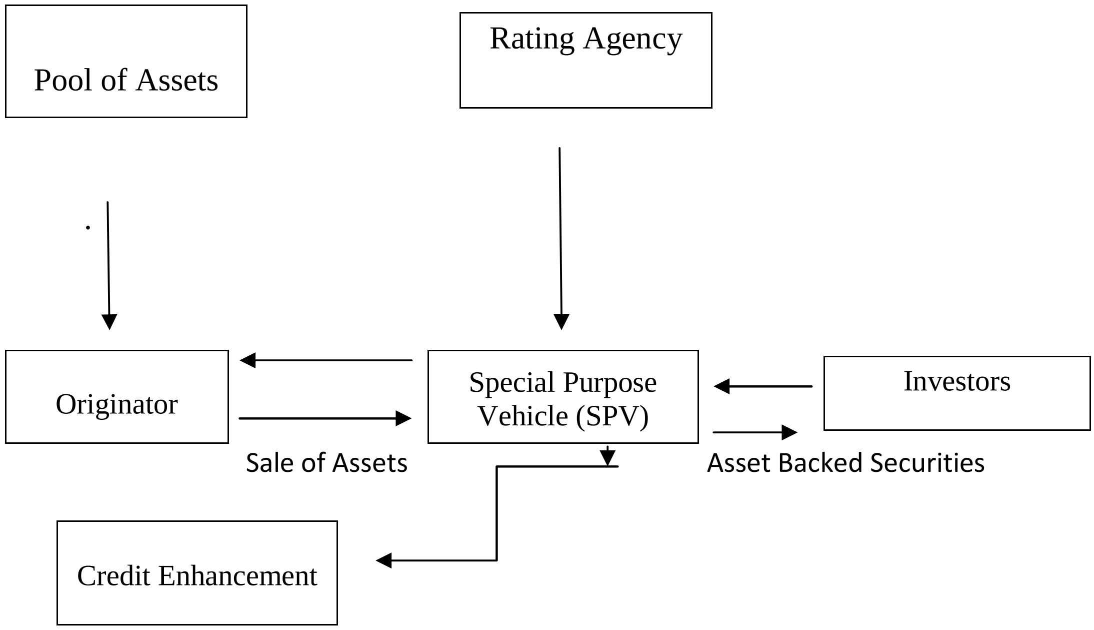

FIGURE 8

3.6 Revenue Sharing Bond

A revenue bond is a type of bond that can be issued by a municipality. With this type of bond, the coupon payments for investors will be generated by a specific project that was paid for with the bond funds. This technique is commonly used by municipalities in order to fund large projects. A common example of this type of bond is when a municipality will issue bonds in order to fund a stadium project. The stadium will generate a large amount of revenue and it will be passed onto the municipality. The municipality will then use part of the money that is generated from project to pay the interest that is due to investors.[102] This type of bond also includes interest. Borrow made payments with interest fee. Turkey used asset backed security first on 'Bogazici Bridge'. Ozal government made security issuance to the public backed by bridge income.

[102] http://www.finweb.com/investing/the-revenue-bond.html (11.05.2011)

3.7 Sukuk

The Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) defines sukuk as certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity. In simple term sukuk is a right for both ownership and claim over the underlying asset or its usufruct substantiating the issuance of such sukuk. Sukuk has now becoming a preferred financing option for governments and corporate across the globe. This phenomenon led the international fraternity to jump on the Islamic finance bandwagon. (Anna Maria Samsudin, 2008). Presently there is an ever growing global market forshari'ah-compliant bond term as sukuk. Basically, there are two types of sukuk, debt-based sukuk and equity-based sukuk. Both are created to facilitate financing for capital requirement of businesses and the governments. Subsequent to the issuance process**,** the sukuk shall then be readily securitized.

3.8 Conclusion

Varying of financial products would bring prosperity but on the contrary deep economic crisis happens because of these financial products. Diversification of financial products neglected risk perception of financial institutions. These financial products may have satisfied needs of people but these products used to gain more profit by banks. Risk appetite of banks affected the whole world. The first rule of banking sector is 'do not give credit who cannot pay it' but during 2000's especially in America banks give credit who cannot afford it because they get their premiums parallel with their profits. Financial sector affected real sector automatically, a lot of factories closed so many people got unemployed. Crisis feed crisis so the deepest economic crisis occurred in 2008. Financial regulators have been raising concerns over the credit derivative markets boom because the risks taken by the investors outside the regulatory purview. Although the derivative markets and hedging instruments facilitate the expansion of the bond market, the evolution of derivative products has brought in two distinctive features to the financial market: an increasing complexity of instruments, which combine an extensive use of derivatives with customization to individual investors' needs and the fragility of off-balance sheet structures and vehicles, which was rediscovered during the recent sub-prime turmoil. Following the sub-prime issue, a number of central banks in developed economies acted to stabilize markets and forestall a potential financial crisis. The European Central Bank, The US Fed injected significant amounts and in order to encourage banks to come to it for liquidity, the Fed reduced the discount rate the charge it makes for emergency lending to banks. The central banks of Canada, Japan, UK and Australia also intervened to provide liquidity to the market. This recent episode also highlights that regulators are required to play a major role indirectly in finance product innovation, in view of the systemic and economic risks. Regulators are required to ensure that systemically important banks and financial institutions are not exposed to concentration risks in specific products or markets. Banks and financial institutions are also required to follow fair market practices without unduly affecting public confidence.

CHAPTER 4

4. SUKUK

Sukuk is alternative Islamic financial tool which does not include interest and it is lured investors because of being less risky than other financial certificates. In this chapter we will define sukuk structure, sukuk types and sukuk implementation in the world. There will be some data about sukuk issuance in late years. Before recommending new sukuk model, it is better to explain what sukuk is.

4.1 Why Sukuk ?

Sukuk is becoming popular financial tool so it needed to be studied. Studies about sukuk are not enough. Not only Islamic countries are interested about sukuk but also western economies are curious bout sukuk. Vatican's declaration about economic crisis showed us that sukuk could be core financial tool for more solid economy. Sukuk literature is still setting up so some terms about sukuk is copy of other financial tools' terms. Islamic financial tools should have its unique terms so that Muslims will not have doubts about its accordance to Islam. Special Purpose Vehicle (SPV) is taken from asset backed securities and we think that it is not suitable for sukuk. We propose 'Sukuk Intermediary' instead of SPV. It will be called 'Sukuk Intermediary' in this thesis. Terms are so important because people think by words.

4.2 Definition of Sukuk

Sukuk (plural of sakk), frequently referred to as "Islamic bonds", are certificates with each sakk representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a mudarabah). These assets may be in a specific project or investment activity in accordance with Shari`ah rules and principles.

Sukuk differs from conventional interest-based securities or bonds in a number of ways, such as, the funds raised through the issuance of sukuk should be applied to investment in specified assets rather than for general unspecified purposes. This implies that identifiable assets should provide the basis for Islamic bonds, since the sukuk are based on the real underlying assets, income from the sukuk must be related to the purpose for which the funding is used, the sukuk certificate represents a proportionate ownership right over the assets in which the funds are being invested. The ownership rights are transferred, for a fixed period ending with the maturity date of the sukuk, from the original owner (the originator) to the sukuk holders. Generally, Sukuk are asset-backed, stable income, tradable and Shari'ah compatible trust certificates. The primary condition of issuance of Sukuk is the existence of assets on the balance sheet of the government, the monetary authority, the corporate body, the banking and financial institution or any entity which wants to mobilize the financial resources, the identification of suitable assets is the first, and arguably most integral, step in the process of issuing Sukuk certificates. Shari'ah considerations dictate that the pool of assets should not solely be comprised of debts from Islamic financial contracts.

The AAOIFI (Accounting and Auditing Organization for Islamic Financial Investments) defines investment Sukuk as follows:

"Investment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after the receipt of the value of the Sukuk, the closing of the subscription and employment of funds received for the purpose for which the Sukuk was issued.''[103]

The Sukuk was developed in Malaysia (which holds today nearly 60 percent of the total Sukuk market) as a type of investment very similar to conventional bonds, but without the payment of interest. The development sukuk has been growing so fast for the last couple years since the first issuance in Malaysia in the early 1990s, known as Islamic Private Debt Securities (IPDS). However, in

[103] www.aaoifi.com/aaoifi_sb_sukuk_Feb2008_Eng.pdf

Indonesia, sukuk just issued in 2001 by PT Indosat Tbk, a telecommunication company based on mudharabah basis. It is just like an Islamic accepted bill (IAB), an al-dayn instrument created based on the framework of murabahah. Both sukuk and IAB are traded in the secondary market based on the principle of al-dayn or exchange of debt. Whilst, pricing of sukuk in its dealings in the secondary market is at a discount to the value payable by the issuer upon maturity.

Although there is no compulsion to comply with the rulings of the Fiqh Academy of the Organization of the Islamic Conference, their rulings carry considerable weight with most Islamic financial institutions and their Shari'a committees and advisers. At the request of delegates from Jordan, Pakistan and Malaysia, the Fiqh Academy considered the question of Islamic investment certificates at their fourth annual plenary session held in Jeddah in February 1988. They noted that the Shari'a encourages the documentation of contracts as stipulated in sura 2:282 of the Holy Qur'an: 'When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. …It is more just in the sight of God, more suitable as evidence and more convenient to prevent doubts among yourselves'

The essence of Sukuk is to provide Shariah compliant instruments for investment which do not involve interest and excessive uncertainty (Gharar). The Sukuk market has been a primary area of growth, providing an avenue for the short and medium-term placement of funds by investors. This development has been fuelled not only by the desire of institutions to raise funds in a Shariah compliant manner but also by investor demand for such products. Sukuk are entitlement to rights in certain assets inclusive of some degree of asset ownership. These Sukuk are more commonly based on Ijarah, Salam, Mudaraba, Musharakah, and Murabahah, Istisna mode of finance and on the basis of pooled portfolios. Sukuk promises the global financial arena many opportunities for managing the capital needs of the emerging economies of the Islamic world in a manner consistent with Islamic values.[104]

The aim of bond traders usually is to make capital gains as fixed-interest bond prices increase when variable market interest rates fall. Bond trading is therefore largely about exploiting interest rate developments and trading in paper that is usually unrelated to the value of any underlying asset. The major risk for holders of conventional bonds is of payments default, but this risk is usually assessed solely on the basis of credit ratings, with the ratings agency rather than the bond purchaser estimating the risk. Hence the bonds are regarded as mere pieces of paper with third parties estimating the risk and the purchaser, at best, only making a risk/return calculation without any reference to the business being financed.

A number of Shari'a scholars, most notably Muhammad Taqi Usmani, have stressed that one of the distinguishing features legitimizing Islamic finance is that it must involve the funding of trade in, or the production of, real assets.[105]

[104] Billah, Mohd. Ma'sum. (2006). Shar'iah Standard of Business Contract. Kuala Lumpur, Malaysia: A.S. Noordeen.
[105] Usmai, Muhammad Taqi (2002). An Introduction to Islamic Finance ,The Hague: Kluwer Law International,, p. 14–16.

SUKUK STRUCTURE

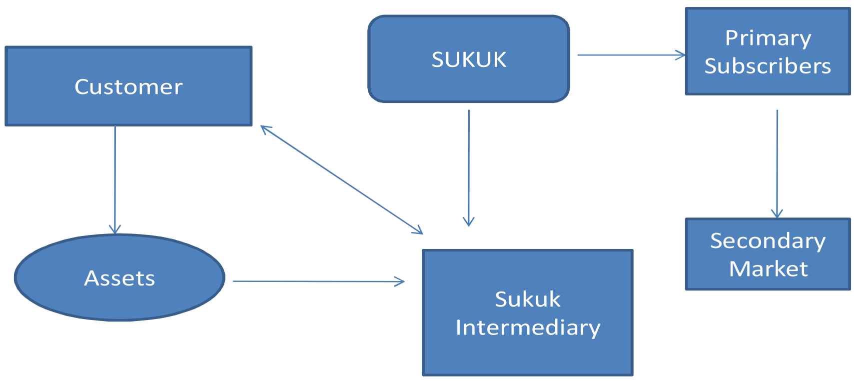

FIGURE 9

Sukuk structure is shaped above, for example a company want to issue Sukuk amount of 100 million USD, first customer sells assets it owns for 100 million USD, second Sukuk Intermediary leases back the assets, Sukuk Intermediary creates a trust in respect of the assets and issues 100 million USD to raise 100 million USD Sukuk, at last Sukuk Intermediary distributes the lease rentals to sukuk holders. The sukuk can be listed and rated. Some internet portals like www.sukuk.me lists sukuk issuance and some finacial rating institutions give rating notes to sukuk.

4.3 Types of Sukuk

Sukuk can be of a number of types based on the Shariah modes as the underlying contract or sub-contract, most important of which are shirakah, ijarah, salam and istisna. Thus, the rates of return on sukuk will be either variable (in case the modes on second leg are participatory) or quasi-fixed (in case of modes with fixed return). Sukuk of the second category can be made fixed return sukuk through the provision of any third party guarantee (Islamic fiqh Academy, 1985–2000: 65).

Zero-coupon non-tradable Sukuk is; another possible classification of Sukuk structures can be created where the assets to be mobilized do not exist yet. Consequently, the objective of the fund mobilization would be to create more assets on the balance sheet of company through Istisna'. However, certificates of this nature would not readily be tradable because of Shari'ah restrictions. The primary asset pools to be generated would be of the nature warranted by Istisna and installment purchase/sale contracts that would create debt obligations. The certificate on these debt arrangements can be termed as fixed rate zero coupons sukuk.[106]

In terms of the use of funds mobilized by financial institutions, following may be the categories of sukuk: mudarabah sukuk, musharakah sukuk, sukuk of ownership in leased assets, sukuk of ownership of usufructs, salam sukuk, istisna sukuk and murabahah sukuk.

Table 5

Sukuk Types which have Second Market	Sukuk Types which have not Second Market
• İjarah Sukuk	• Murabahah Sukuk
• Musharakah sukuk	• Istisna sukuk
• Mudarabah Sukuk	• Bay-al Salam Sukuk

4.3.1 Mudarabah Sukuk

These are certificates that represent projects or activities managed on mudarabah principle by appointing any of the partners or any other person as mudarib for management of the business. In terms of the Resolution of the Islamic fiqh Academy of the OIC (2000: 61-65), following are the salient features of mudarabah certificates; Mudarabah sukuk represent common ownership and entitle their holders share in the specific project against which the Mudarabah Sukuk have

[106] Shaukat M. ' Common Structures of Sukuk' www.instiuteofhalalinvesting.org (01.05.2011)

been issued. The Mudarabah Sukuk contract is based on the official notice of the Issue or the Prospectus which must provide all information required by Shariah for the Qirad (rent) contract such as the nature of capital, the ratio for profit distribution and other conditions related to the issue, which must be compatible with Shariah. The Mudarabah Sukuk holder is given the right to transfer the ownership by selling the deeds in the securities market at his discretion. Market value of muqaradah deeds varies with the business status and anticipated or expected profits of the concerned project. Sale of mudarabah sukuk must include some features in order to obey Islamic like, If the mudarabah capital, before the operation of the specific project, is still in the form of money, the trading of Mudarabah Sukuk would be like exchange of money for money and it must satisfy the rules of bay-al sarf (Bay-al sarf is the Exchange of same currencies like gold with gold or gold with silver, today fiat Money is used so it refers to Exchange of dollar with dollar), If capital is in the form of combination of cash, receivables, goods, real assets and benefits, trade must be based on the market price evolved by mutual consent. Second The Manager/Sukuk Intermediary who receives the funds collected from the subscribers to Mudarabah Sukuk can also invest his own funds. He will get profit for his capital contribution in addition to his share in the profit as mudarib. Third Neither prospectus nor Mudarabah Sukuk should contain a guarantee, from the Issuer or the manager of the fund, for the capital or a fixed profit, or a profit based on any percentage of the capital. Fourth It is permissible to create reserves for contingencies, such as loss of capital, by deducting from the profit a certain percentage in each accounting period. The last rule is The prospectus can also contain a promise made by a third party, totally unrelated to the parties to the contract, in terms of legal entity or financial status, to donate a specific sum, without any counter benefit, to meet losses in a given project, provided such commitment is independent of the mudarabah contract. However, it is not permissible for the issuer to guarantee the capital of the mudarabah (OIC Fiqh Academy, 2000: 61-65).Islam accepts risk so not to enter interest implementation always risk factor should be exist. [107]

[107] Shaukat M. ' Common Structures of Sukuk' www.instiuteofhalalinvesting.org (01.05.2011)

4.3.2 Musharakah Sukuk

These are certificates of equal value issued for mobilizing funds to be used on the basis of partnership so that their holders become owner of the relevant project or the asset as per their respective shares that are part of their assets portfolio. Musharakah sukuk can be issued as redeemable certificates by or to the corporate sector or to the individuals for their rehabilitation/employment, for purchase of automobiles for their commercial use or for establishment of high-standard clinics, hospitals, factories, trading centers, endowments, etc. Musharakah redeemable sukuk are relatively similar to mudarabah sukuk. Therefore, basic Shariah (ah rules relating to mudarabah would also apply to musharakah certificates). The only major difference is that the intermediary-party will be a partner of the group of subscribers represented by a body of musharakah certificate holders in a way similar to a joint stock company (Hamoud, 1998). An excellent example of musharakah sukuk are the 5-years Term Finance Certificates (TFCs) worth Pak Rupees 360 million issued by Sitara Chemical Industries, a public limited company in Pakistan in June 2002. These TFCs for the period of 5 years are based on the mechanism of profit and loss sharing and are tradable in the Securities Market. The payment of profit to or sharing of loss with the TFC holders are linked to the operating profit or loss of the Company. The exact rate of profit on investment in the TFCs is not possible to be determined for each year in advance. The investors assumed the risk of sustaining losses proportionate to their principal amount in case of operating losses incurred by Sitara. Changes in any government regulations may also affect the profitability of the TFCs. By investing in the TFCs, the investors also assume the risk of not being able to sell the TFC without adversely affecting the price.[108]

4.3.3 Ijarah Sukuk

Ijarah sukuk are the securities representing ownership of well defined existing, defined and known assets tied up to a lease contract, rental of which is the return payable to sukuk holders. By dint of flexibility in rules of ijarah, securitizing

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108 Ayub M. Securitization, Sukuk and Fund ManagementPotential to be Realized by Islamic FinanciaI institutions

the ijarah contracts is a key factor in solving liquidity management problems and for financing the public sector needs in developing countries. Payment of ijarah rentals can be unrelated to the period of taking usufruct by the lessee. It can be made before beginning of the lease period, during the period or after the period as the parties may mutually decide. This flexibility can be used to evolve different forms of contracts and sukuk that may suit different purposes of issuers and the holders. Governments can use this concept as alternative tool to interest based borrowing provided they have durable assets useable in the process of performing government functions. Use of assets by the Governments is necessary while it does not matter whether these assets are income generating or not. It is necessary for an ijarah contract that the asset being leased and the amount of rent both are clearly known to the parties at the time of the contract and if both of these are known, ijarah can be contracted on an asset or a building that is yet to be constructed, as long as it is fully described in the contract provided that the lessor should normally be able to acquire, construct or buy the asset being leased by the time set for its delivery to the lessee. The lessor can sell the leased asset provided it does not hinder the lessee to take benefit from the asset. The new owner(s) would be entitled to receive the rentals of remaining period. Similarly, they can dispose of their share in the asset to the new owners individually or collectively. Rental in ijarah must be stipulated in clear terms for the first term of lease, and for future renewable terms, it could be constant, increasing or decreasing by benchmarking or relating it to any well known variable like inflation rate, any periodically announced price index, or otherwise by any settled percentage. As per Shari[ah rules, expenses related to the corpus or basic characteristics of the asset are the responsibility of the owner, while maintenance expenses related to its operation are to be borne by the lessee. Therefore, the expected return flow from such sukuk may not be completely fixed and determined in advance. In this perspective ijarah sukuk should be taken as Quasi fixed return instruments in Islamic finance.[109]

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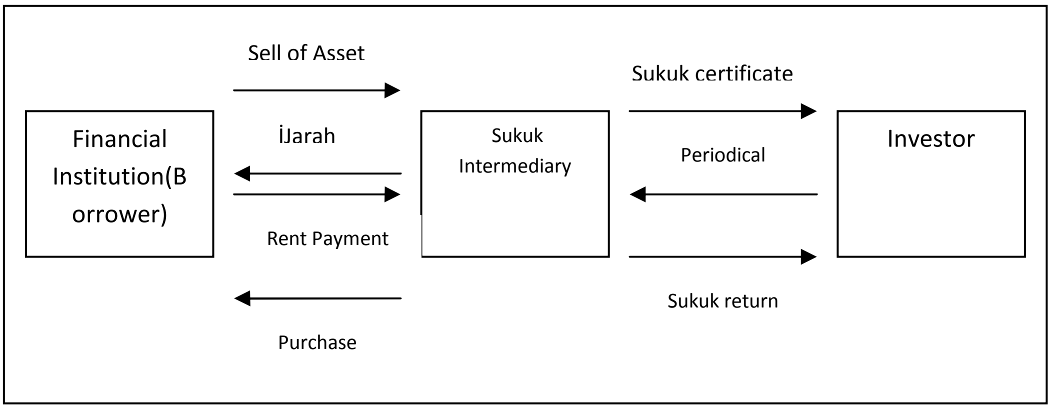
[109] Ayub M. Securitization, Sukuk and Fund ManagementPotential to be Realized by Islamic FinanciaI institutions



Source: Dar Al Istithmar, 2006

FIGURE 10

4.3.4 Istisna Sukuk

Istisna is a contractual agreement for manufacturing goods allowing cash payment in advance and future delivery or a future payment and future delivery of the goods manufactured as per the contract. It can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, bridges, roads and highways. By way of parallel istisna contract with subcontractors, Islamic banks can undertake the construction of any asset and its sale for a deferred price, and sub contract the actual construction to any specialized firm. In istisna, full ownership of the constructed item is immediately transferred to the purchaser against the deferred sale price that normally covers not only the construction costs but also profits which could legitimately include, inter alia, the cost of tying funds for the duration of the repayment period. The payable deferred price can be documented in the form of sukuk (certificates of indebtedness) known as istisna sukuk. Prohibition of riba precludes the sale of these debt certificates to a third party at any price other than their face value. Therefore, such certificates which may be cashed only on maturity cannot have a secondary market. However, they can be transferred at face value to a third party. The builders, big industrial concerns and whole-sale suppliers can sell to the IFIs certain assets on istisna basis on deferred payment and issue istisna sukuk redeemable periodically according to their payment dates. The holders of istisna sukuk may acquire against them property or merchandise for a deferred price. Once acquired, such property or merchandise can be disposed of in any manner. As indicated earlier, the deferred price of goods acquired against such certificates would be higher than the spot price of the same goods. The certificate holder acquiring the goods now at higher than the spot price is in fact relinquishing to the seller of the goods some, (all, or even more) of the price differential which the former obtained from the client above the construction cost of the project he financed. This would mean that the market forces can play a role in encouraging or curtailing the exchange of these certificates for goods.[110]

4.3.5 Salam Securities

Salam is a contract in which advance payment of price is made for goods to be delivered later on. It is not permissible to sell the commodity concerned before receiving it. Therefore, the recipient may not resell the salam-commodity before receiving it, but he may resell the commodity by another contract which is parallel to the first one. In this case, the first and the second contracts should be independent of each other. Specifications of the goods and delivery dates of the two contracts may conform to each other, but both the contracts would be independently enforceable. Salam sale is attractive to the seller whose cash flow is enhanced in advance and to the buyer as the salam price is normally lower than the prevailing spot price. The BMA, in June 2001, developed salam based securities with LIBOR-related 3- months tenure used by Islamic banks for liquidity management. Bahrain government sells aluminum to Bahrain Islamic Bank which has been nominated to represent the other banks wishing to participate in the salam contract. The Government of Bahrain undertakes to supply a specified amount of aluminum at a future date. At the same time, BIB appoints the Government its agent to market the aluminum at the time of delivery through its channels of distribution at a price which provides a return to security holders. The possibility of having negotiable salam certificates is yet to be decided. So far, scholars are not inclined to accept it. It needs sound analysis of

[110] Al-Bashir M.(2008). Sukuk Market:Innovations and Challenges, Islamic Economic Studies, p.15

reselling goods purchased under salam before taking possession by the original buyer especially in the situation when he maintains inventory of that kind of goods in which case banks would be selling those goods out of the stock maintained by them without specifying any units of the goods. If it is allowed, the salam sukuk could be negotiable.[111]

4.3.6 Murabahah Sukuk

Any 'Paper' representing a monetary obligation arising out of a credit sale transaction by banks cannot create a negotiable instrument. While murabahah receivables cannot fetch any return, their assignment also has to be at face value. Murabahah Sukuks are more likely to be used in respect of purchases of goods by the public sector. In case the government needs items of huge price, it may purchase them through credit sale by paying in installments. The seller will amortize his cost and return (profit margin) over the period of installments. The government will issue certificates according to the number of instalments. Each certificate having maturity date would represent property right of the seller that can change hands provided amount of the claim does not change. The seller or the original certificate holder can transfer his collection rights to another party against payment that would be equal to the face value of the certificate minus collection cost at the transferee's end. Any 'murabahah Funds' can also issue murabahah sukuk proceeds of which could be used for sale of pre-specified and general assets on the basis of murabahah to give quasi fixed return to the murabahah sukuk holders.[112]

4.4 Disadvantages of Sukuk Structures

Sukuk is a financial tool so like other financial tools sukuk also have some financial risks. If there were no risk it would not be halal (appropriate) in Islamic rules. Risks adverse effect the competitiveness of an asset's pricing. The novelty of Sukuk inherently entails a higher exposure to certain market and financial risks.

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[111] Ayub M. Securitization, Sukuk and Fund ManagementPotential to be Realized by Islamic FinanciaI institutions
[112] Ayub M., Securitization, Sukuk and Fund ManagementPotential to be Realized by Islamic FinanciaI institutions

An important distinction is made between market risks and other types of risk factors. Market risk is defined as the risk on instruments traded in well-defined markets. Two categories of market risks are identified: general (systematic) and firm specific (idiosyncratic). Systematic risks can arise due to governmental and economic policy shifts whereas idiosyncratic risk arises because different firm specific instruments are priced out of correlation with other firms’ instruments.

This can be considered as a rate of return risk as far as Sukuk are concerned. It may be mentioned again that Sukuk based on fixed rates are exposed to this risk in the same manner as fixed rate bonds are exposed to the interest rate risk. The rise in market (interest) rates leads to the fall in the fixed-income Sukuk values. Sukuk certificates are exposed indirectly to interest rate fluctuations through the widespread benchmarking with LIBOR in their financing operations because investors compares sukuk and other bonds when they decide to invest so sukuk market is effected by bond market. Most of investor invests according to rate of return only few of them concerns over Islamic sensitivity. Capitalism unfortunately effects Islamic market. Consequently, the nature of these assets is that they are exposed to fluctuations in the LIBOR rate or even the market rates. For example, the mark-up is a defining characteristic of the Murabahah contract that is currently the most popular Islamic financial instrument on the asset side of the balance sheet. Every contract benchmarked with LIBOR inherits the possibility that in the future the LIBOR rates will rise and that the issuer, on the asset side, will not have made as much profit as future market conditions might dictate.[113]

Currency risk arises from unfavorable exchange rate fluctuations which will undeniably have an effect on foreign exchange positions. In the event of a divergence between the unit of currency in which the assets in the Sukuk pool are denominated, and the currency of denomination in which the Sukuk funds are accumulated, the Sukuk investors are rendered to an exchange risk.

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[113] Tariq A.(2004). Managing Financial Risks of Sukuk Structures, Loughborough University Press

The IDB serves as a guarantor and thus protects the investors from any exchange rate fluctuations. Indeed, the investors in all the Sukuk prospectuses are shielded through similar provisions. However, this does not eliminate the exchange risk faced by the originators. In truth, exchange rate risks are compounded with a rapidly growing industry and increasingly multi-national investment arrangements. The challenge for Sukuk issuing corporate entities and sovereigns becomes to devise an effective exchange risk management strategy congruent to Shari'ah principles.

Credit risk refers to the probability that an asset or loan becomes irrecoverable due to a default or delay in settlements. If the relationship involves a contractual arrangement than the counterparty risk is the probability that the counterparty retracts on the conditions of the contract. The consequences can be severe with a decline in the value of a bank's assets. The credit and counterparty risks inherent in Islamic finance are unique owing to the nature of Islamic financial instruments that become the foundation of the Sukuk asset pools. Unlike conventional financial institutions, Islamic banks do not have access to derivative instruments and other credit risk management mechanisms due to Shari'ah considerations.[114]

4.5 Advantages of Sukuk Structures

Transparency and clarity of rights and obligations; that income from securities must be related to the purpose for which the funding issued, and not simply comprise interest; and, that securities should be backed by real underlying assets, rather than being simply paper derivatives. Islamic fixed-income securities are already emerging as a significant class of asset, and areas potentially important for the Muslim investor as conventional bonds are for investors generally. In addition, for non-Muslims who already own conventional bonds, the acquisition of sukuk introduces a new asset class into their portfolios, bringing further welcome diversity

[114] Tariq A.(2004). Managing Financial Risks of Sukuk Structures, Loughborough University Press

and possibly reducing risk. Conventional bonds that yield interest, or riba, are of course prohibited under Shari'a law. Furthermore, those who buy and sell conventional bonds are rarely interested in what is actually being financed through the bond issue, which could include activities and industries that are deemed haram such as the production or sale of alcohol. Companies that are highly leveraged with bank debt may seek refinancing through issuing bonds, but such companies are not regarded as suitable for Muslim investors. Number of Shari'a scholars, most notably Muhammad Taqi Usmani, has stressed that one of the distinguishing features legitimising Islamic finance is that it must involve the funding of trade in, or the production of, real assets[115] Merely funding the purchase of financial securities would involve second order financing akin to lending for derivatives, the subsequent gearing being speculative and increasing uncertainty, or gharar. Hence, with murabaha, commodities are purchased on behalf of a client and resold to the client, the temporary ownership of the commodity justifying the financier's mark-up.

4.6 The Financial Development in Twentieth Century

Financial tools heavily differentiated after rise of free market and development of electronic devices. During 19th century financial transactions made by paper. Financial tools were meaning only borrowing and lending. At the end of the century electronic devices started to enter financial environment. Use of finance and meaning of finance changed after globalization of the world. Arbitrage, hedging, future agreements began more prevalent not only in the developed countries but also in developing countries companies, people and governments began to use new financial tools.

Financial intermediaries is the another debated issue in finance sector. Is intermediaries increase efficiency of financial sector or decrease efficiency? Some academicians claims that intermediaries is not the audience of the financial activity, Besides identifying the best production technologies, financial intermediaries may

[115] Usmai, M. Taqi(2002). An Introduction to Islamic Finance ,The Hague: Kluwer Law International

also boost the rate of technological innovation by identifying those entrepreneurs with the best chances of successfully initiating new goods and production process according to King and Levine, This lies at the core of Joseph Schumpeter's (1912, p. 74) view of finance in the process of economic development. He said in his book that''The banker, therefore, is not so much primarily a middleman … He authorizes people in the name of society … (to innovate).''

On the other hand financial intermediation increases transaction cost because intermediaries want their commission from transactions. It is accepted that financial market should be transparent and information could be get by everybody, but intermediaries hinder this theory. Intermediaries hide information and earn money by their information.

International bond market is important but local bond market is important too. Deeper financial market is more useful for developed countries and emerging countries. There is a growing consensus among policymakers, academics, and market participants regarding the importance of local currency bond markets for financial stability. Global institutions, including the IMF, BIS, World Bank, and OECD, have highlighted the importance of local bond market development, and regional organizations such as the Asian Development Bank have championed. Attention focused on local bond market development following a series of currency crises in emerging economies that revealed the financial fragility associated with a currency mismatch. The development of local currency bond markets in emerging economies could contribute to global financial stability in a number of ways. First, by reducing reliance on foreign currency debt—and its concomitant currency mismatches, emerging economies would be less likely to repeat the experience of the Asian financial crisis (Goldstein and Turner 2004; Eichengreen and Hausmann 2005; Burger and Warnock 2006). Second, local bond markets play an important role in the broader goal of financial development which in turn is linked to economic growth and poverty reduction (Levine 2005, 2008). Third, the development of local currency bond markets has the potential to mitigate the global shortage of sound and liquid financial assets described by Caballero, Farhi, and Gourinchas (2008).

Bond markets automatically affected by other factors like inflation, money supply etc… Especially in the twentieth century economic circumstances changed and traditional policies did not work. Inflation effects bond market. After patrol crisis in 1973 high inflation occurred around the world. There are several adverse consequences of high and volatile inflation on the efficient functioning of bond markets. The rise in inflation requires central banks to adopt a tight monetary policy stance with a contraction of market liquidity. Money market liquidity, especially the liquidity in the inter-bank market, facilitates smooth functioning of other segments in the money market such as secondary market of Treasury bills and private sector money market instruments such as commercial paper. The reduction in inter-bank liquidity will therefore negatively affect the liquidity in bonds and raise the volatility of market rates leading to a reduction in activities of the secondary markets, which provides price discovery. Another consequence of the volatility in inflation is the building of inflationary expectations. These expectations discourage investors from allocating resources financial assets, in particular long-term bonds. This affects corporate bonds as well as government bonds and overall financial savings of the country. The Government then requires borrowing from inflationary sources, further building up inflationary pressures. High inflationary expectations and volatility of short-term rates also cause the market participants to have problems in deciding on future path of long-term interest rates. Uncertainty of future rates causes higher preference in investing in short term paper shortening the yield curve. From a macroeconomic perspective, inflation affects foreign currency inflows and country's competitiveness adversely. If domestic inflation is higher than those of other countries, a country's exports will be less competitive and hence in less demand in international markets. There will also be less foreign currency inflows through foreign direct inflows and portfolio flows. These again negatively impact on the overall bond market. As Nobel Prize winner economist Milton Friedman quoted 'inflation is always monetary concept'. Inflation is a very close association with expansion in money supply, budget deficits and currency depreciation. High inflation is largely a result of higher growth of money and fiscal deficits financed by banking sources, especially by central bank which increases reserve money and fuels the overall monetary growth, thereby leading to inflation. The private sector has also been borrowing from the banking sources creating additional pressure for monetary management, partly a result of non development of alternative sources of financing.

According to Ananda Silva who is the director of Bank Supervising Department in Central Bank of Sri Lanka 2008 ‘’the developments in bond markets improve the efficiency of monetary management. Banks, which are the main counter parties in the implementation of monetary policy, take into account their borrowings and lending decision based on market determined yield curve. Accordingly, changes in the monetary policy stance are reflected in the markets and improve the transmission of monetary policy. A developed bond market reduces the need for governments to finance its budget deficits from inflationary banking financing. Therefore, bond market is an alternative channel for mobilizing funding which enhances the flexibility of monetary management. The development of government securities market also facilitates implementing indirect instruments of monetary policy. Most countries are moving away from the use of direct instruments to indirect instruments such as repos and direct open market operations. Typically, Treasury bills and Treasury bonds are the main instruments used in conducting repo transactions. Central banks in general, absorb and inject liquidity through the purchase and sale of Treasury bills/Treasury bonds. An important component in the management of liquidity is crucially dependent on development of money market and Treasury bill and Treasury bond markets in particular. The development of Treasury bill and Treasury bond markets therefore contribute for the Central Bank to conduct monetary policy more effectively.’’[116]

Bond market development has a significant impact on strengthening financial system stability. Well-functioning government and corporate bond markets expand the array of financial assets that are available to institutional investors. Long-term investors such as pension funds and life insurance companies require long-term investments that mach their long-term liabilities. Market determined investments reduce mismatches and facilitate their portfolio management. In this context, bond

[116] Silva A.(2008). Bond Market Development: Monetary and Financial Stability Issues, e-book

markets help strengthen the balance sheets of these institutions and reduce their exposures to interest rates and roll over risks of investments. Another important advantage is that it reduces instabilities arising from foreign Currency mismatches and the dependence on international bond markets by corporations. In fact, combined with a sound debt management policy, domestic bond market allows a reduction of the exposure to other financial risks since bond market provides an alternative and cost efficient source of medium and long-term capital for corporations. Moreover, a market-oriented funding policy based on a liquid government securities market will reduce debt-service costs over the medium to long-term. A liquid corporate bond market may prevent development of asset price bubbles. Bond markets expand the array of financial instruments available to diverse investors. Yield curve allows investors to infer more information about market expectations regarding interest rates and other economic developments. With the expansion of market players in the market, the herd behavior will also be restricted. Development of bond markets facilitates and expands the opportunities to financial institutions to raise debt capital. Specially, this is important since banks are required to build capital with the implementation of new Basel capital accord. The development of other ancillary intermediaries such as rating agencies can support the overall credit risk management of financial intermediaries.’’

Development of capitalism brought new needs to investors and businessmen. One of them is future markets. Future markets based on trade of future. Future markets include options, swap, and forward transactions. Forward is trading of currency price. For instance a business man has a USD debt and TL income so businessman tries to protect himself from currency risk. Forward provides setting unique price to foreign currency. He signs an agreement with a bank or insurance or fund company to set a price to currency he will have currency at that price whatever the price of currency occurs in that date. Swap is exchanging interest liabilities of two parties. For example a company has fixed rate interest liability and another company has fluctuated interest liability but those companies want to change their type of liabilities so they sign an agreement and shoulder other’s liability. Options transaction is buying option of ‘buy right’ of a stock, bond or currency. One purpose of these exotic products is to create new securities that could be sold to a broader group of investors such as pension funds and insurance companies whose investment horizon better suited depending on their liability structures. These instruments therefore enabled the transfer of credit risk to a diversified group of investors in the market. Therefore, these innovative products were generally encouraged, even by regulators, as a risk management tool. Markets evolved to trade these securities to suit investors with different risk appetites.

Attention and discussion by policymakers and practitioners has centered on an extensive range of regulatory and infrastructure initiatives that involve: improving regulation and the rule of law; enhancing financial market transparency; providing stronger investor protections and rights; improving clearing system performance and the reputation of local rating agencies; and providing the necessary stable macroeconomic policies to encourage investment.’’[117]

The crisis which occurred in 2008 brought some new approaches to financial sector. First of all as Keynes quoted, markets may not be in order without administrative interruption. Sometimes markets go wrong way if nobody audit them.

4.7 Sukuk Implementations in Countries

Sukuk is an Islamic financial toll so sukuk is more prevalent in Islamic countries but especially after global economic crisis which occurred in 2008 Islamic financial methods are more interested in European countries. Sukuk first used in Malaysia. Islamic finance holds the highest market share in Malaysia. Malaysia was the most appropriate country that sukuk can be applied.

4.7.1 Sukuk in Malaysia

Malaysia Global Sukuk was incorporated in Labuan, Malaysia as a special-purpose vehicle solely for the purpose of participating in the Sukuk issuance transactions. On July 3, 2002, the government of Malaysia issued trust certificates

[117] Asian Develpoment Bank Working Paper (2009). p. 173

worth U.S. $ 600 M that was due in 2007. Each of the trust certificates represents an undivided beneficial ownership of the trust assets that are the land parcels. The proceeds from the issuances were implemented to develop the land parcels that consisted of four areas of construction; Selayang Hospital, a government owned hospital operated by the Ministry of Health, Tengku Ampuan Rahimah Hospital, a government owned hospital operated by the Ministry of Health, Government living headquarters in Jalan Duta, Jalan Duta Government Office Complex (including Ministry of Finance, Ministry of International Trade and Industry, and Inland Revenue Board offices).

A Sukuk Intermediary is created to buy the land parcels from the government (that is funded by both Islamic and conventional investors) which are then leased back to the government that pays out rental payments matching the semi-annual distribution amounts to the Sukuks. Indeed, this is the generic arrangement of Ijarah Sukuk issuances.

Under the framework of the Malaysian prospectus, the "master Ijarah" agreement would entitle the government to distribute semi-annual lease payments in reference to LIBOR + 0.95% that would exactly match the distributions to the Sukuk holders. After the expiry of the agreement in 2007, the government will buy back the properties at face value effectively protecting the bond issue from any variations in the value of the underlying assets. The rental return is guaranteed by the government of Malaysia, and the trust certificates are thus equivalent to floating Malaysian sovereign debt instruments. The certificates were rated "Baa2" by Moody's Investor Services and "BBB" by Standard & Poor's Rating services. The lead manager of the issuance was HSBC and the co-managers included ABC Islamic Bank, Abu Dhabi Islamic Bank, Bank Islam, Dubai Islamic Bank, Islamic Development Bank, Maybank International and Standard Chartered Bank.Applications were made to list the certificates on the Luxembourg Stock Exchange and the Labuan Financial Exchange.[118]

[118] Tariq A.(2004). Managing Financial Risks of Sukuk Structures, Loughborough University Press, p. 33-35

4.7.2 Ijarah Corporate Sukuks: Gutherie

The Serial Islamic Lease Sukuk issuance by First Global Sukuk in partnership with certain Malaysian subsidiaries of Kumpulan Gutherie, provides an interesting case study of an alternative structure for Ijarah Sukuks. The arrangement implemented different 'series' of Sukuks (similar to conventional securitization tranches) as well as call and put options. Furthermore, the fact that the seller is a corporate rather than government means that there are numerous varying risk considerations to explicate. First Global Sukuk is a Sukuk Intermediary incorporated in Labuan, Malaysia specifically for the purpose of this particular Sukuk arrangement. On December 24, 2001 Gutherie issued trust certificates in two series (Series A and Series B) with a total value of U.S. $ 150 M. Series A comprised of U.S. $ 50 M of certificates due in 2004, and the remaining U.S. $ 100 M were incorporated in Series B due in 2006. The distinctions between Series A and Series B Sukuk are in the land parcels, the different sellers (various subsidiaries of Gutherie), the semi-annual returns, ownership profit and the terms to maturity.

The arrangement has provisions for Gutherie and its subsidiaries to be able to issue further Sukuks on other land parcels. Distributions on such further issuances will be derived from Gutherie's payments under the relevant lease agreements with the Sukuk Intermediary. Additional trusts will have to be created for this additional certificates but it has been estimated that the total value of future issuances would not exceed U.S. $ 245,000,000.[119]

4.7.3 Sukuk in Qatar

Qatar Global Sukuk QSC was incorporated as a joint stock company in Doha during October 2003, established as a joint-venture Sukuk Intermediary by the government of Qatar, Qatar International Islamic Bank (QIIB) and HSBC. On 8th October, 2003 the government of Qatar issued U.S. $700 million worth of Trust

[119] Tariq A.(2004). Managing Financial Risks of Sukuk Structures, Loughborough University Press,p. 35-36

Certificates (Sukuk) due 2010. The proceeds from this issuance were utilized to finance the construction and development of the Hamad Medical City located in Doha, Qatar. Each certificate holder has an undivided beneficiary right to the land parcel (which is the medical complex) between October 2003 and 2010. Under the arrangement, the Sukuk Intermediary buys the parcels from the government of Qatar and re-sells them to the buyers of the issues. It does so by buying the beneficiary rights and keeping them as a trust and issuing trust certificates (known as sukuk) to the investors. The distribution dates are the ninth day of every April and October. The Sukuk Intermediary, on behalf of the investor, leases the land parcel back to the government of Qatar in conformity with the Master Ijarah Agreement. Under the terms of the agreement between the issuer (lessor) and government (lessee) the rental payments will be calculated semi-annually (in April and October) with reference to LIBOR plus the margin, and will equal the periodic distribution amounts payable on the respective dates. These rental payments are equivalent to the semi-annual distribution funds. The returns are guaranteed by the government of Qatar and thus replicate floating rate Qatari sovereign debt instruments. The certificates were rated A+ by Standard & Poor's (S&P) and applications were proposed to be made to list the issuances on both the Luxembourg Stock Exchange and the Labuan International Financial exchange (Malaysia).[120]

4.7.4 Sukuk in Bahrain

On 13 June 2001, the Bahrain Monetary Agency offered, for the first time in the Gulf, government bills that were structured to comply with Shari'a Islamic law.[121] The bills were worth US$25 million, and were in the form of three-month paper, referred to as sukuk salam securities. Although the Malaysian government has offered Islamic bonds since the 1980s, some governments in the Arab world have been forced to borrow in international markets rather than locally because of Islamic objections to trading in debt and interest-based securities. Governments have issued paper that the local commercial banks have held to maturity, but not traded. This,

[120] Tariq A.(2004). Managing Financial Risks of Sukuk Structures, Loughborough University Press, p. 31-32

[121] www.euromoneyplc.com

however, restricts the liquidity of bank assets and makes it more difficult for the government to raise finance directly from the public. With its new sukuk salam securities, Bahrain has overcome this problem by providing a fixed return, equivalent to 3.95 per cent at an annualized rate, for the first Islamic bill issue which is not based on interest. The return has been calculated in relation to the real benefit the government expects to obtain on the funds, rather than with reference to market interest rates. The first securities matured on 12 September 2001 and a new issue was launched, a process that has been repeated every three months.

The establishment of the Islamic money market in Bahrain will, it is hoped, result in the emergence of markets in longer-term Islamic securities, notably bonds, with Bahrain playing a similar role in the Gulf and west Asia to that of Kuala Lumpur in South-east Asia. The initial offer of bills in June 2001, worth US$25 billion, was oversubscribed with almost US$60 million being offered. The minimum subscription was fixed at US$10,000, which meant that relatively small financing houses could participate as well as private investors seeking a non-banking home for their dollar-denominated liquidity. The same minimum subscription limit was set for the longer-term ijarah leasing securities, worth US$100 million, that were offered in August 2001. These were issued on 4 September 2001 and will mature in 2006. They offer a rental return of 5.25 per cent per annum guaranteed by the government of Bahrain. By October 2003, the total sukuk portfolio managed from Bahrain exceeded US$1 billion.[122]

4.8 Sukuk Market Today

The Sukuk market has emerged during the previous three years, first Bahrain issuing domestic sovereign fixed-rate Ijarah and Salam Sukuk. It was followed by the issuance of floating rate Ijarah Sukuk as well as pooled Sukuk by both corporate bodies and sovereigns in several countries. These Sukuk are based on Salam, Ijarah, Istisna, Istisna-cum-Ijarah and on the basis of pooled portfolios. We discuss some examples of the Ijarah Sukuk and pooled portfolio securitization.

[122] Wilson R. Islamic Bonds: Your Guide tı Issuing,Structuring and Investing in Sukuk, Overview of the Sukuk Market, www.euromoneybooks.com, p.12

We should learn a lesson from UAE situation despite sukuk is backed by real economic value if one invests more than he or she can afford, there is risk at all. Sukuk market is about 1 trillion USD today, and estimated to grow. 2008 global economic crisis showed that economic bubbles which are not based by real economic value is risky and will exploit anyway. Sukuk market is dominated by Asian an Gulf states such as Malaysia, Saudi Arabia and Bahrain. On the other hand sukuk become popular in England, America and other western countries. HSBC Amanah (Islamic department of HSBC) is one the main Islamic banking institution which issues sukuk in England and to other western countries. Citibank has also an Islamic banking department. Citigroup agreed with Dow Jones to found a sukuk index which is called 'Dow Jones Citibank Sukuk Index'. Normally western governments do not issue sukuk, because they issue government treasury bonds they don't need Islamic ruled bond because of low demand.

It is expected that private sukuk issuance will grow more than public issuance. Because of western corporations' interest in sukuk more than recent years. Government is looked less risky than private sector normally nevertheless in sukuk private issuance and government issuance is very similar because sukuk is backed by building, infrastructure investment bridge or any another economic value if an issuer cannot pay its debt it may sell real economic value and pay its debt. '
Table in the below it is listed some sukuk issuance;

Table 6

Corporate Issuer	Country	Issue Date	Issue Size (million)	Coupon
Standard Chartered Bank	Malaysia	Dec-04	USD 100	-
Durrat Al Bahrain Sukuk	Bahrain	Jan-05	USD152	Libor3m+1.25
The Commercial Real Estate Sukuk	Kuwait	Ma-05	USD 100	Libor 6m+1.25
Rantau Abang Capital	Malaysia	Mar-06	MYR 2029	4.91 fixed
The Nakheel Group	UAE	Dec-06	USD 3520	6.345fixed
Dubai Ports Authority	UAE	Jan-06	USD 3500	7.125 - 10.125
Daar International Sukuk	Saudi Arabia	Jul-07	USD 1000	Libor 3m+1.94
Aldar Properties	UAE	Feb-07	USD 2530	5.767 fixed

***Source:** IMF Working Paper 2007

4.9 Sukuk in Turkey

4.9.1 Economic History of Turkey

Republic of Turkey emerged from ruins of the great Ottoman Empire. After independence war during 1918-1923 first target of the Turkey become an independent nation. The founder of Turkey Republic Mustafa Kemal ATATURK organized Izmir Economy Congress before declaring governance type of Turkey in 1922.Organization of the economic congress depicts the degree of the importance Turkish Republic to economy. According to Mustafa Kemal economic independence is as important as political importance. In Izmir new republic declared mixed economic program. State controlled economy and liberal economy will implement together. There was no capital to invest so state should interrupt economy. On the other hand private sector encouraged to invest and shoulder burden of the economy. During 1920's economy growth was quite high it was not surprising because nation has gain its independence new. During 1930' Turkey affected from global crisis so growth slowed. Until 1980 Turkish economy was based on state. Private sector did not develop as expected. Import-substitute model was applied until 1980. Some giant companies took production rights of foreign companies and they tried technology transfer. However it did not work Turkey had huge budget deficits, trade deficits and high inflation rates. Periodically Turkey had to devalue its currency to finance its foreign trade deficit. All of the governments applied fixed exchange rate during 1960-1990 so central banks need huge foreign currency reserves, but to have foreign currency nation should have exports. Turkey's export rate is so low. The export-led growth strategy of the early 1980's by Ozal government was quite successful. The average annual growth rate of real gross domestic product (GDP) was an impressive 5.8 percent in 1981-1988 and the economy did not experience any recession, making the country an exemplary one in annual reports of international financial institutions such as the IMF. Also, the real increase in industrial value added was above the GDP growth rate; it averaged 8.1 percent during the same period.

The Turkish economy has experienced relatively high inflation coupled with unsuccessful disinflation programs during 1980-2000. Although yearly inflation was over 100 percent in certain years, it never reached hyperinflationary levels but increased in a stepwise fashion over time: the average annual inflation rate was 20 percent in the 1970s, 35-40 percent in the early 1980's, 60-65 percent in the late 1980s and early 1990s, and around 80 percent before the government launched yet another disinflationary program in 1998 An early attempt to reduce inflation on a permanent basis and to put the economy on a sustainable growth path began on January 24, 1980. The government declared its intention to liberalize the economy, and to pursue an export-led growth policy. After the implementation of the program, a military regime was installed in September 1980. The January 24 program reached its initial targets very soon in terms of a lower inflation, a higher GDP growth and a relatively liberalized external trade regime and financial system. However, after the general elections and a new parliament in 1984, inflation started to rise again. The basic elements of disinflation efforts in the late 1980s were in various forms of nominal anchoring and monetary tightening without any serious effort to reduce the public sector borrowing requirement. This policy combination necessitated a higher interest rate on domestic assets and a lower depreciation rate in order to secure short-term capital inflow. Especially after 1989 (the year the capital account was liberalized), the new disinflationary strategy pronounced itself strongly. However, the government did not take necessary measures on the fiscal front and the disinflationary attempts were futile. Due to the unsustainable nature of the fiscal policy and the external deficit, the economy experienced a major crisis in early 1994. The Government announced a new stabilization program on April 5, 1994 and a stand-by arrangement was approved by the International Monetary Fund (IMF) Board two months after the program started. However, it soon became clear that the government was not strongly behind the April 5 program and the stand-by agreement came to an end in 1995. During the following two years, there was no serious attempt to stabilize the economy and to reduce inflation.[123]

In July 1998, the Turkish government started another disinflation program under the guidance of an IMF Staff Monitored Program (SMF). The program achieved some improvements concerning the inflation rate and fiscal imbalances but it could not relieve the pressures on the interest rates. The Russian crisis in August 1998, the general elections in April 1999 and two devastating earthquakes in August and October 1999 led to a deterioration of the fiscal balance of the public sector The government started implementing another far-reaching restructuring and reform program after the general elections in April 1999. The aim of the program was to reduce inflation from its current 60-70 percent per year to single digits by the end of year 2002. The program gained further momentum after the country signed a stand-by agreement with the IMF in December 1999. The main tool of the disinflation program was adoption of a crawling peg regime, the percent change in the Turkish lira value of a basket of foreign exchanges (1 US dollar plus 0.70 Euro) is fixed for a period of a year and a half. Although there was turmoil in financial markets in late

[123] Ertuğrul A. and Selçuk F.(2001). A Brief Account of the Turkish Economy:1980-2000, e-book, p. 1-3

November and early December 2000, the program seems to be on track as of February 2001 thanks to a substantial infusion of additional funds from the IMF after the crisis in December 2000. This short-lived financial crisis showed that the financial system is very fragile. Ironically, the crisis made it clear that the continuation of the disinflation program and the stability of the banking system in the short run depend on short-term capital inflows. Therefore, unless the government creates an environment in which foreign direct investment finds itself comfortable, the program is probably destined to fail and inflation might start to rise again. The dynamics of the growth performance of the Turkish economy after 1989 can be linked to unsuccessful disinflationary efforts and debt financing policies of the government. The Turkish policy makers started to slow down the depreciation rate of the Turkish lira, in part to control the inflation, but mainly to be able to borrow easily from the domestic markets in 1989. Although there was a crisis in 1994 which interrupted this policy, the Turkish authorities have pursued the same exchange rate policy for the last ten years. Ozal saw that import substitution growth policy cannot be sustainable so he changed policy and liberalized financial an real sector. Istanbul stock exchange, Board of Capital Markets Board of Turkey (SPK) was found by Ozal to order liberal financial system. The export-led growth policy was quite successful in the early stages of its implementation. The openness of the economy increased immediately: the total exports-GDP ratio increased from 4.1 percent to 13.3 percent during the period of 1980-1988. The total imports - GDP ratio also increased but the rate of increase was smaller as it went up from 11.3 percent to 16.4 percent during the same period. Therefore, the external balance situation improved significantly. The external deficit-GDP ratio went down from 7 percent in 1980 to negative 1 percent (surplus) in 1988. The real depreciation of the Turkish lira (approximately 40 percent) and several tax incentives to exporters in this period were the major driving forces of the export-led growth policy.

Despite the fact that the program achieved some remarkable results in a short period of time, the Turkish financial system experienced a short-lived crisis at the end of year 2000. During the second half of the year 2000, the slowdown in economic reforms in general and the opposition to the privatization of certain state enterprises from inside the government increased the suspicion in the market that the program was about to end.[124] In February 2001 Turkey had the deepest economic crisis in its history. Visible reason of the crisis was the dispute between prime minister and the president in National Security Council but it was not the real reason. Economy was so fragile and so dependent to foreign direct investment which is called ‘hot money’. During 2001 crisis, banking system collapsed. A lot of banks bankrupted. Interest of government bonds increased to %200 and repo rate increased to %1000. Debts of the governments are going to unpayable rates. Bill of the crisis was near 50 billon USD. Turkish citizens are still paying that bill by high taxes. A coordinator minister came from World Bank whose name is Kemal Derviş. Stand-by agreement signed with IMF. IMF freed 1,5 billon USD credit quickly. IMF imposed some financial measures such as fluctuating currency rate, reforms in banking system, central bank independence. Turkish government made reforms compulsory. After 2001 crisis Turkey started reconciliation program freed its currency value. Banking sector reformed. Government guarantee to all banks removed. Financial sector liberalization accelerated. Budget equality program implemented and it was successful. Inflation lowering program also implemented. Inflation was the main problem of Turkish economy. Inflation rate make economy more ambiguous and investors could not see what will happen in the future. After 2001 Turkish governments focused on inflation, budget deficits decreased, money supply also controlled. IMF supported that program. Reforms contracted economy little bit, unemployment rate increased but it was compulsory to lower inflation.

The recent restructuring and reform program aims at reducing the inflation to single digits and putting the economy into a sustainable growth path. A financial crisis during the course of the program showed that the financial system is very fragile. Ironically, the latest crisis also made it clear that the continuation of the disinflation program and the stability of the banking system in the short run depend on short-term capital inflows.

[124] Ertuğrul A. and Selçuk F.(2001). A Brief Account of the Turkish Economy:1980-2000, e-book, p. 4-7

Today Turkey has high growth rate, and inflation is so low. Inflation rate decreased to %5 and USD dollar reserve of central bank increased to 76 Billion USD. Until 2008 most of developed countries suffering from economic crisis but Turkey did not affected so much from crisis. Thanks to reforms which applied in 2001 crisis. Turkey were experienced about financial crisis first time in the history Turkey used bad experiences for good results. After 2003 Turkey's growth type changed in spite of liberalization efforts which hold by Ozal, Turkey was still import substitution policy for growth, but today Turkey is growing by export led policy. Turkey's export increased to 113 billion USD. Despite drastic increase Imports are over exports, because Turkish exports are based on semi-ended row materials. Export rate increases but also import rate grows.

4.9.2 Sukuk Application in Turkey

Islamic finance debated in Turkey a lot. Turkey introduced Islamic banking in 1984 by special finance law. AlbarakaTurk found in 1984 as first 'Special finance Institution'. There are 4 Islamic Finance Institution today named BankAsya, Turkiye Finans, Kuveytturk and Albaraka. After 2001 crisis Turkey reorganized its banking sector so 'Special Finance Institution' changed, Islamic finance banking now called 'Participation Banks'. As explained above Participation Banks hold %6 of total banking sector.

Turkey ordered sukuk by law very late. Capital Markets Board of Turkey (SPK) declared sukuk notification in 1 April 2010. Notification prepared to ordered sukuk issuance and sukuk market in Turkey but it explained only basic rules because there is no sukuk market before notification.

Goals of sukuk notification are, first governments can indebt more easily because a real economic value is exhibited to investors so investors will trust more, second attracting investors who have some money but do not want be included in interest market because of Islamic sensibility and attracting gulf capital countries who gained a lot of money by oil. Turkish financial market could not deepen as expected. Gulf capital and Muslim people will bring deepening to financial sector.

In 2001 crisis foreign capital got away from Turkey so crisis deepened. Main management rule says that' do not put all eggs in the same basket' turkey did not implement this rule and suffered because of one sided foreign capital. Secular environments in Turkey has fears about gulf capital, when a Islamic business man come to Turkey media reports about regime is changing and tend to be like Iran or other gulf states so Islamic finance and sukuk is became a feared financial tool.

First sukuk issuance made by KuveytTurk (Turkey branch of Kuveyt Finance House Financial group) participation bank at the amount of 100 million USD in December 2010. Type of sukuk was ijarah sukuk. Ijarah sukuk is the most prevalent sukuk type used in the world. Kuveytturk backed sukuk by its buildings. The profit of sukuk is about %14, means that sukuk will bring more than 10 million USD. Expiry date of sukuk is 3 year. At the end of 3 year Kuveytturk will rebuy its building and pay nominal value of sukuk holders. There is no another sukuk issuance in Turkey. Standard Charter Bank's Turkey branch Standard Unlu Stock declared that they are planning to issue sukuk amount of 1 billion USD but they have not issued yet.

Turkish government has not issued sukuk. In 1984 Ozal government issued 'Profit Sharing Bond' based on to highways and bridges. But it has differences between sukuk and profit sharing bonds, in profit sharing bonds there is no rent or sell action so it is not Islamic correct because of having profit without any real economic action.

Turkey should widen sukuk base, one sukuk issuance is not enough. Participation bank market is not so developed but holds %6 of the market sukuk should hold more than %6 of bond market because sukuk has some price and usage advantages according to bonds. Sukuk market and Islamic banking market may feed each other grow of sukuk will result grow of participation banking sector in Turkey.

4.10 Conclusion

Especially after 2008 world economic crisis Islamic finance and sukuk are perceived more risk averse, real market oriented and has resistance to crisis. Western world curiosity increased after 2008 to Islamic finance. Today sukuk is the major alternative way to bond market all over the world.

In 2010 Sukuk issuance is near 30 billion USD according to IFFS report. . Most issuance made in gulf region such as Saudi Arabia, Bahrain, Qatar… but the leader country is first sukuk issuer Malaysia. Sukuk market also effected from global economic crisis. The record sukuk issuance made in 2007 near 33 billion USD. According to Moody's estimation -credit rating institution- in 2011 sukuk issuance will have a record that will equal to near 35 billion USD. UAE had sukuk crisis in 2010 some sukuk issuer could not pay coupon payments because of crisis. UAE started huge investments like apartments, houses, highways etc. and issued sukuk to have an liquidity to these investments but crisis prevent cash flow to these investments so coupon payments of sukuk could not be payed. UAE situation decreased trust to sukuk certificates nevertheless sukuk is more safe than interest bond because sukuk is based on real economic property if issuer could not pay rent fee property could be sold and main capital of sukuk holders will be pay.

CHAPTER 5

5. NEW SUKUK MODEL FOR TURKEY

Sukuk has not developed market in Turkey. As explained above only one sukuk issuance has made by KuveytTurk participation Bank. Euromoney gave Kuveytturk innovation prize because of sukuk issuance[125]. Sukuk may be very good alternative for Turkey. Turkish financial sector has not deepened as ought to be. One of its reason some Turkish people do not invest in bonds or stocks because of their Islamic sensitivity. On the other hand oil rich gulf capitals do not invest interest bonds because of ban in Islam so turkey needs IMF or other western nation when it needs capital or debt. Suku may be a good instrument for Turkey for this two reason financial deepening and luring gulf capital.

Turkey needs new and different sukuk implementation because Turkey has different economic situation than other sukuk issuer countries. In this thesis we will try a new sukuk model for Turkey and other countries. After unrest in Middle East some scholars claimed that Turkey can be a model about its democracy. If Turkey implement a new successful sukuk model may be Turkey will be a good example for other nations.

Turkey has unique economic and social factors. Social factors effect economic situation because economic activity is about people of course some institutional factors are important but human factor is more important. Turkey has secular democracy until 1923 so its economic situation based on its secular democracy. Turkey found its economic institutions looking to Western Europe.

Interest is widely used by government and giant companies. Interest rates, currencies, measurement, calendar changed and imitated to Europe. So economy is based on interest. Interest is used by government also. ‘Turkish Trade Law’ is

[125] www.kuveytturk.com.tr

translated from Switzerland[126] trade law so economic relations are ordered by western thought so Turkey has a lot of differences from sukuk user gulf nations. Nevertheless in recent years Turkey's middle class start to change and new rich middle class has more Islamic sensitivity so Islamic institutions begin to develop. Participation banking sector is a good example for this change. Participation banking sector grew very fast in recent years.

Sukuk is widely used in Islamic countries. Ijarah sukuk is more prevalent than other types of sukuk. In Ijarah sukuk as explained, a company or government sells its building, car or another economic value to a Sukuk Intermediary, then Sukuk Intermediary rent that building to the same company or government, Sukuk Intermediary gets rent earning. Sukuk issued by Sukuk Intermediary and sukuk coupons pay by Sukuk Intermediary with rent earning. In general application every sukuk issuance needs new Sukuk Intermediary foundation. Sukuk Intermediary is structured as a company.

In new sukuk model which could be suggested, there will be only two Sukuk intermediaries, one of them for government sukuk issuance and the other one is private sector. The model proposes that government found a Sukuk Intermediary for its all sukuk issuance. Another Sukuk Intermediary is found for private sukuk issuance. These two SPV will organize and issue all sukuk in Turkey. Private Sukuk Intermediary could be found by a company or private sector representative like The Union of Chambers and Commodity Exchanges of Turkey (TOBB)[127].

The sukuk issuance has two sides one of them is government sukuk issuance and the second one is private sukuk issuance. First in government issuance (Turkish government has not made yet) Sukuk Intermediary will declare government plans to issue sukuk, and Sukuk Intermediary will take demand from companies or public. After collection of demand Sukuk Intermediary will buy the economic value (building, car, machine etc.) and rent to the sukuk issuer company. Sukuk Intermediary will have

[127] www.tobb.org.tr

rent income with that rent income sukuk coupon payments to the sukuk issuer. At the maturity date sukuk issuer will buy its economic value from Sukuk Intermediary. Sukuk Intermediary will pay sukuk amount to sukuk holders. If there is profit from sukuk processes- in general it will be- government founded Sukuk Intermediary will transfer profit to state budget. Government sukuk should be open to public purchase so sukuk will expand wider base of the community. Not only giant companies have sukuk profits but also public who has little savings will be pleased about sukuk profits.

In private sector, a Sukuk Intermediary will be found by a company or non-profit private organization like The Union of Chambers and Commodity Exchanges of Turkey (TOBB), Sukuk Intermediary should be objective to all parts of private sector. Sukuk Intermediary should have beginning capital to fund sukuk processes. Sukuk Intermediary will collect demand from public and companies. Sukuk Intermediary will buy an economic value and rent to the sukuk issuer. Coupon payment will be pay to the sukuk holders regularly. The profit got from sukuk process should be added to company capital.

The biggest city of United Arab Emirates, Dubai had debt crisis in 2009 because of over indebting[128]. Sukuk debts were a lot and Dubai had to delay its debt payment. This example showed even if sukuk is less risky than bonds it has risk. If a company or country cannot order its liquidity to finance sukuk payment sukuk holders get loss because of sukuk. Values of economic asset decrease so sell of economic asset do not prevent loss only it decreases loss.

Dubai example proves that sukuk implementation is important. Founding new Sukuk Intermediary for all sukuk issuer concludes uncontrolled sukuk issuance and over debt. In Turkey control of private sector is more difficult than other countries this situation has a lot of reasons but this is not our study topic for example Turkish tax income is coming from indirect taxes companies do not inform tax collectors

[128] Aksam Newspaper, www.aksam.com.tr (05.07.2010)

correctly[129]. If every sukuk issuer founds its own Sukuk Intermediary control of sukuk issuance is impossible or so difficult. Dubai crisis showed us that control of debt ratio is important lack of foresight of companies will expense too much for citizens because economic crisis affect all citizens in that country.

The most important advantage of single Sukuk Intermediary is decreasing transaction cost. Company foundation is a tired process, one need a lot of signature and tax fee to found a company. Sukuk Intermediary is a company if every sukuk issuer found a Sukuk Intermediary to issue sukuk the cost of sukuk will be increased. Central Sukuk Intermediary will decrease transaction cost and time waste. Today electronic signature might be used; it is accepted by law so documents could be prepared in electronic environment. Central Sukuk Intermediary will implement sukuk issuance more effective by electronic usage.

Secondly central Sukuk Intermediary could be audited more effectively. Auditing is one of the primary missions of government. Turkey suffered banker corruptions in 1980's some banker (not institutional bank there were some people who were lending money to people) got money from people with claiming giving more interest, in conclusion they took people's money and did not pay their money. After these bad experiences, Turkish people could not trust company founded Sukuk Intermediary. So for Turkey central Sukuk Intermediary will be more effective and reliable. Capital Market Board of Turkey (SPK) or Undersecretariat of Treasury could audit central Sukuk Intermediary both of government founded and private founded. Auditing of one central Sukuk Intermediary will be easier for governmental institutions.

Nevertheless, central Sukuk Intermediary is not the only need for sukuk. Sharia board also should be central. One Sharia Board will decide for all sukuk issuance in Turkey if it is appropriate to Islam or not. In gulf or Asian countries also in Turkey all Islamic financial institutions have their Sharia Board. Different applications of

[129] www.gib.gov.tr (Revenue Administration)

different Sharia Boards destruct consumers rely on Islamic finance. For standardization in sukuk implementations only one sharia board should be exist. Name of unique, central Sharia Board might be ‘Sukuk Regulation and Supervision Board’.

Applications on Islamic Banking could be differing from one bank to another so it makes customer more suspicious about Islamic Banking. Same risk exists in sukuk implementation. For example in participation banking one bank make funding for service but other participation bank do not fund service sector, so consumer confused about Islamic finance applications, rumors walk around ‘there is differences between banks’ in conclusion reliance on participation banking sector decreased. Second effect is if Sharia Board does not approve an application senior management begins to press to Sharia Board saying that’ they are approving why don’t you approve we are losing customer’ so if Sharia Board is not so powerful for then they accept that implementation reluctantly. Existing of a lot Sharia board cause no standard in decisions and flexion of Islamic Banking. Presidency of Religious Affairs may appoint Sharia Board, cooperation with private sector. Presidency of Religious Affairs is reliable institution which most of people accept its decisions. By this way speculations that sukuk is not implemented in the Islamic way will be end.
Return rate of sukuk is another important subject. Global applications have differences; some issuers offer fixed return some issuers offer labor indexed return. It may be mentioned again that Sukuk based on fixed rates are exposed to this risk in the same manner as fixed rate bonds are exposed to the interest rate risk.[130] Return indexed return is not appropriate for Turkey, it might be convenient to Islamic principles but interest indexed return is perceived as interest by people. Participation banking criticized about nearness of profit rate to interest rate so some people have suspicions on Islamic banking. To prevent these criticisms return of sukuk should be fixed like rent price or instead of LIBOR average of ‘participation return’ of Participation Banks should be used. There should not be any linkage between interest applications and sukuk return. Any linkage between sukuk and interest based ratio,

[130] Tariq A. (2004). Managing Financial Risks of Sukuk Structures, Loughborough University Press

people will run off from sukuk. Sukuk return-coupon payment- may be decreased if rent price of economic value decrease or increased if rent price of economic value increase. Participation Banks return ratio could show that average ratio of return on real projects so return of sukuk have arranged to market return.

Size of sukuk tried to be estimate but there is not any econometric analysis about market size of sukuk in Turkey. Standard Unlu –Standard Chartered Bank's Turkey agent- claims they can issue 1 billion USD sukuk in Turkey. Standard Unlu talks about only private sector sukuk issuance there should be governmental issue also. Oil rich gulf countries will invest to Turkish sukuk so governmental sukuk issue can be about 5 billion USD in first step. Sukuk market will grow year by year in the future. Dictators of Middle East begin to alter and public of that region is against Western Europe, America. Demand of Gulf States to Turkish bond investment will increase if sukuk could be used more effectively. Private sector sukuk market will be about 1 billion at first stage USD because participation banking in turkey has not grew as expected only %6 of banking sector belongs to participation banks. If demand of sukuk will above of estimated size so other banks also begin to issue sukuk. To sum up it could be expected that Sukuk market will be 6 billion USD in a few years in Turkey of course economic situation will affect sukuk market size but economy begin to recover in Turkey after 2008 crisis.

CHAPTER 6

CONCLUSION

Interest is accepted as unprecented concept in today’s capitalized world. Capitalism based on interest and most of academicians behave that debates over interest is over and no need to discuss it. On the other hand it can be seen that interest has some disadvantages and harmful sides for society. Interest results capital collection to one rich side of the society. One side who takes risk and try to do business may have loss but lender always gets its interest. In this situation taking risk is not preferred one so all people who has some capital lend people to have interest fee in the conclusion production of the society will collapse. Interest is forbidden In all religions but we should explain why it is forbidden if someone do don believe in a religion prohibition does not mean anything to him.

Interest is also forbidden in Islam nevertheless banking actions are compulsory today’s trade environment. Islamic countries found Islamic banks which do not include interest proceedings to avoid interest and make banking actions. Islamic Banks have crucial role in Islamic countries. Market share of Islamic Banks increase every year. Turkey welcomed Islamic banks in 1980’s first their names were ‘Special Financial Institutions’ after 2000 banking law changed in Turkey so their names changed new name is ‘Participation Banks’. Also in Turkey market share of participation banks increasing and it seems to be increase. Especially after 2008 world economic crisis interest free financial tools started to be more popular. Western economies start to understand interest-free financial tools. Increase of alternative financial instruments needs more research which can be made by academicians.

Sukuk is another type of alternative financial tool. Now sukuk is used around the world not only by Islamic countries. Ijarah Sukuk –type of sukuk which is based on rent- is the most widely used sukuk type. Sukuk has also some risks and problems, it is not the perfect financial tool but every financial tool has some disadvantages so sukuk has a few disadvantages compared with interest based bonds.

Turkey declared sukuk statement after tough discussions. Sukuk is very new topic for Turkey. Turkey got late in sukuk because of ideological disputes. Turkey's elite has tough secular thoughts if any tool is related with religion or Arabs, elites are always against them. Turkey's main target was luring rich gulf capital to invest in Turkey. Muslim Gulf countries like Saudi Arabia, Kuwait, Malaysia or Bahrain do not invest in Turkey because of interest included financial tools. After declaration of sukuk law gulf capital will start to invest in Turkey.

Sukuk market has not ordered in Turkey so new and different sukuk model might be implemented in Turkey. Central Sukuk Intermediary and central Sharia board could make sukuk less risky and more effective in Turkey. Fixed return of sukuk will make sukuk more reliable to interest avoider people. These recommendations could be seen not important innovation nevertheless small adjustments can make huge efficiency increase in financial tools.

We hope more academicians will be curious about alternative financial tools so economic crisis which originated from interest will end.

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