

What is Islamic Banking?

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Conventional bankers and Islamic banking

Ask a conventional banker exactly what is Islamic banking. He will mumble something about religion. He will then say well they cannot charge interest but they use something else which is the same thing. This ‘something else’, incidentally, is never defined. He will then move on to describe Islamic banking as being about smoke and mirrors. To conclude he will then profoundly announce that, with a few tweaks, it is what he does every day anyway. And that is the end of it.

If you push him to actually describe an Islamic financial instrument, and even worse if you actually use some Islamic terminology, Murabaha, Mudaraba etc, then his eyes will start to glaze over.

Frankly this stereotyped image is all too prevalent within the conventional banking world. In an endeavour to both enlighten conventional bankers and to broaden the understanding of Islamic banking principles this chapter will go back to basics and will highlight the key characteristics of Islamic banking which differentiate it from conventional banking.

As you will learn, Islamic banking is not about smoke and mirrors. It is in fact about banking based on Islamically-ethical principles which are, in many ways, very different indeed from conventional banking principles.

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So what exactly is Islamic banking all about?

Islamic financial institutions are those that are based, in their objectives and operations, on Qur’anic principles. They are thus set apart from ‘conventional’ institutions, which have no such religious preoccupations. Islamic banks provide commercial services which comply with the religious injunctions of Islam. Islamic banks provide services to their customers free from interest (the Arabic term for which is *riba*), and the giving and taking of interest is prohibited in all transactions. This prohibition makes an Islamic banking system differ fundamentally from a conventional banking system.

Technically, *riba* refers to the addition in the amount of the principal of a loan according to the time for which it is loaned



and the amount of the loan. In earlier historical times there was a fierce debate as to whether *riba* relates to interest or usury, although there now appears to be a consensus of opinion among Islamic scholars that the term extends to all forms of interest.

The term *riba*, in Islamic law (the *Sharia'a*), means an addition, however slight, over and above the principal. According to the Federal Sharia'a Court of Pakistan, this means that the concept covers both usury and interest; that it applies to all forms of interest, whether large or small, simple or compound, doubled or redoubled; and that the Islamic injunction is not only against exorbitant or excessive interest, but also against even a minimal rate of interest. Financial systems based on Islamic tenets are therefore dedicated to the elimination of the payment and receipt of interest in all forms. It is this taboo that makes Islamic banks and other financial institutions different, in principle, from their Western conventional counterparts.

There are a range of modern interpretations of why *riba* is considered *haram* (forbidden) but these are strictly secondary to the religious underpinnings.

The fundamental sources of Islam are the Holy Qur'an and the *Sunnah*, a term which in Ancient Arabia meant 'ancestral precedent' or the 'custom of the tribe', but which is now synonymous with the teachings and traditions of the Prophet Muhammad as transmitted by the relaters of authentic tradition (*hadith*). Both of these sources treat interest as an act of exploitation and injustice and, as such, it is inconsistent with Islamic notions of fairness and property rights. While it is often claimed that there is more than this to Islamic banking, such as its contribution towards economic development and a more equitable distribution of income and wealth, its increased equity participation in the economy, etc, Islamic banking nevertheless derives its specific *raison d'être* from the fact that there is no place for the institution of interest in the Islamic order.

This rejection of interest poses the central question of what replaces the interest rate mechanism in an Islamic framework. Financial intermediation is at the heart of modern financial systems. If the paying and receiving of interest is

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prohibited, how do Islamic banks operate? Here profit-and-loss sharing (PLS) principles come in, substituting profit-and-loss sharing for interest as a method of resource allocation and financial intermediation.

The basic idea underlying Islamic banking can be stated simply. The operations of Islamic financial institutions primarily are based on a profit-and-loss-sharing (PLS) principle. An Islamic bank does not charge interest but rather participates in the yield resulting from the use of funds. The depositors also share in the profits of the bank according to a predetermined ratio. There is thus a partnership between the Islamic bank and its depositors, on the one side, and between the bank and its investment clients, on the other side, as a manager of depositors' resources in productive uses. This is in contrast with a conventional bank, which mainly borrows funds, paying interest on one side of the balance sheet, and lends funds, charging interest, on the other. The complexity of Islamic banking comes from the variety (and nomenclature) of the instruments employed, and in understanding the underpinnings of Islamic law.

Six key principles drive the activities of Islamic banks. These are:

1. *the prohibition of predetermined loan repayments as interest (riba);*
2. *profit-and-loss sharing is at the heart of the Islamic system;*
3. *making money out of money is unacceptable. All financial transactions must be asset-backed;*
4. *prohibition of speculative behaviour;*
5. *only Sharia'a-approved contracts are acceptable;*
6. *the sanctity of contracts.*

These principles, as applied to Islamic banking and finance, are set out below.



1 Predetermined payments are prohibited

Any predetermined payment over and above the actual amount of principal is prohibited. Islam allows only one kind of loan and that is *qard al hassan* (literally 'good loan') whereby the lender does not charge any interest or additional amount over the money lent. Traditional Muslim jurists have construed this principle so strictly that, according to one Islamic scholar, "the prohibition applies to any advantage or benefits that the lender might secure out of the *qard* (loan) such as riding the borrower's mule, eating at his table, or even taking advantage of the shade of his wall". The principle derived from the quotation emphasises that any associated or indirect benefits which could potentially accrue to the lender are also prohibited.

2 Profit-and-loss sharing

The principle here is that the lender must share in the profits or losses arising out of the enterprise for which the money was lent. Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business, instead of becoming creditors. Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether these are manufacturing industries, service companies or simple trade deals. Translated into banking terms, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures.

This is unlike the interest-based commercial banking system, where all the pressure is on the borrower: he must pay back his loan, with the agreed interest, regardless of the success or failure of his venture.

The principle, which thereby emerges, is that in order to try and ensure investments are made into productive enterprises Islam encourages these types of investments in order that the community may ultimately benefit. However, Islam is not willing to allow a loophole to exist for those who do not wish to invest and take risks but rather are intent on hoarding money or depositing money in a bank in return for receiving interest



(*riba*) on these funds for no risk (other than the bank becoming insolvent).

Accordingly, under Islam, either people invest with risk or suffer loss by keeping their money idle. Islam encourages the notion of higher risks and higher returns and promotes it by leaving no other avenue available to investors. The objective here is that high-risk investments provide a stimulus to the economy and encourage entrepreneurs to maximise their efforts to make them succeed, with appropriate benefits to the community.

Risk-sharing

As mentioned above one of the most important features of Islamic banking is that it promotes risk-sharing between the providers of funds (investors) and the user of funds (entrepreneurs). By contrast, under conventional banking, the investor is assured of a predetermined rate of interest.

In conventional banking, all the risk is borne by the entrepreneur. Whether the project succeeds and produces a profit or fails and produces a loss, the owner of capital is still rewarded with a predetermined return. In Islam, this kind of unjust distribution is not allowed. In pure Islamic banking both the investor and the entrepreneur share the results of the project in an equitable way. In the case of profit, both share this in pre-agreed proportions. In the case of loss, all financial loss is borne by the capital supplier with the entrepreneur being penalised by receiving no return (wages or salary) for his endeavours.

Emphasis on productivity as compared to creditworthiness

Under conventional banking, almost all that matters to a bank is that its loan and the interest thereon are paid on time. Therefore, in granting loans, the dominant consideration is the creditworthiness of the borrower. Under profit-and-loss sharing (PLS) banking, the bank will receive a return only if the project succeeds and produces a profit. Therefore, it is reasoned, an Islamic bank will be more concerned with the soundness of the project and the business acumen and managerial competence of the entrepreneur.



3 Making money out of money is not acceptable

Making money from money is not Islamically acceptable. Money, in Islam, is only a medium of exchange, a way of defining the value of a thing. It has no value in itself, and therefore should not be allowed to generate more money, via fixed interest payments, simply by being put in a bank or lent to someone else.

The human effort, initiative, and risk involved in a productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital rather than capital, meaning that money becomes capital only when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not capital and, as such, it is not entitled to any return (i.e. interest).

Muslims are encouraged to spend and/or invest in productive investments and are discouraged from keeping money idle. Hoarding money is regarded as being Islamically unacceptable. In Islam, money represents purchasing power, which is considered to be the only proper use of money. This purchasing power (money) cannot be used to make more purchasing power (money) without undergoing the intermediate step of being used for the purchase of goods and services.

4 Uncertainty is prohibited

Gharar (uncertainty, risk or speculation) is also prohibited.

Under this prohibition any transaction entered into should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values (goods received and/or prices paid) intended to be exchanged as a result of their transactions. Also, parties cannot predetermine a guaranteed profit. This is based on the principle of 'uncertain gains' which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount designed to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are



considered as un-Islamic and so are forward foreign exchange transactions, given that forward exchange rates are determined by interest rate differentials.

5 Only Sharia'a-approved contracts are acceptable

Conventional banking is secular in its orientation. In contrast, in the Islamic system, all economic agents have to work within the moral value system of Islam. Islamic banks are no exception. As such, they cannot finance any project which conflicts with the moral value system of Islam. For example, Islamic banks are not allowed to finance a distillery, a casino, a night club or any other activity which is prohibited by Islam or is *known* to be harmful to society.

6 Sanctity of contracts

Many verses in the Holy Qur'an encourage trade and commerce, and the attitude of Islam is that there should be no impediment to honest and legitimate trade and business. It is a duty for Muslims to earn a living, support their families and give charity to those less fortunate.

Just as Islam regulates and influences all other spheres of life, so it also governs the conduct of business and commerce. Muslims have a moral obligation to conduct their business activities in accordance with the requirements of their religion. They should be fair, honest and just towards others. A special obligation exists upon vendors as there is no doctrine of *caveat emptor* in Islam. Monopolies and price-fixing are prohibited.

The basic principles of commercial *Sharia'a* law are laid down in four root transactions:

1. *sales (bai), transfer of the ownership or corpus of property for a consideration;*
2. *hire (ijara), transfer of the usufruct (right to use) of property for a consideration;*
3. *gift (hiba), gratuitous transfer of the corpus of property; and*
4. *loan (ariyah), gratuitous transfer of the usufruct of property.*

These basic principles are then applied to the various specific transactions of, for example, pledge, deposit, guarantee, agency, assignment, land tenancy, *waqf* foundations (religious or charitable bodies) and partnerships.

Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. This is potentially a major problem for Islamic banks, and is discussed below.

What is asymmetric information?

This can be defined as information that is known to one party in a transaction but not to the other.

The classical issue here is that some sellers with inside information about the quality of an asset will be unwilling to accept the terms offered by a less informed buyer. This may cause the market to break down, or at least force the sale of an asset at a price lower than it would command if all buyers and sellers had full information. This is known as the 'lemon market' problem in valuation. A lemon, in this context, refers to a poor quality asset.

This concept has been applied to both equity and debt finance.

For equity finance, shareholders demand a premium to purchase shares of relatively good firms to offset the losses arising from funding lemons. This premium raises the cost of new equity finance faced by managers of relatively high-quality firms above the opportunity cost of internal finance faced by existing shareholders.

In the debt market, a borrower who takes out a loan usually has better information about the potential returns and risk associated with the investment projects for which the funds are earmarked. The lender on the other side does not have as much information concerning the borrowers that he would like.

Lack of enough information creates problems before and after the transaction is entered into. This is potentially a major problem with Islamic profit-sharing financial contracts. The

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presence of asymmetric information normally leads to adverse selection and moral hazard problems.

Information asymmetry comes in two versions.

1. Adverse Selection

This refers to a situation in which sellers have relevant information that buyers lack (or vice versa) about some aspect of product quality. This is the problem created by asymmetric information before the transaction occurs. It occurs with potential borrowers who are the most likely to produce an undesirable (adverse) outcome. Bad credit risks are the ones who most actively seek out a loan and are thus most likely to be selected. Again this is potentially a problem with Islamic profit-sharing financial contracts.

In the simplest case, lenders cannot price discriminate (i.e. vary interest rates) between good and bad borrowers in loan contracts, because the riskiness of projects is unobservable. Thus, when interest rates increase, relatively good borrowers drop out of the market, increasing the probability of default and possibly decreasing lenders' expected profits. In equilibrium, lenders may set an interest rate that leaves an excess demand for loans. Some borrowers receive loans, while other, observationally equivalent borrowers, are rationed.

2. Moral Hazard

Moral hazard is the consequence of asymmetric information after the transaction occurs. The lender runs the risk that the borrower will engage in activities, described below, that are undesirable from the lender's point of view because they make it less likely that the loan will be paid back.

The conventional debt contract is a contractual agreement by the borrower to pay the lender a fixed amount of money at periodic intervals. When the firm has high profits, the lender receives the contractual payments and the lender does not need to know the exact profits of the borrower. If the managers are pursuing activities that do not increase the profitability of the firm, the lender does not care as long as the activities do not

interfere with the ability of the firm to make its debt payments on time. Only when the firm cannot meet its debt payments, thereby being in a state of default, is there a need for the lender to verify the state of the firm's profits.

But if debt interest payments are not being made, as would occur under Islamic financing principles, the moral hazard problem is embedded within the system.

Where does asymmetric risk come from with Islamic banking?

The principle of profit-and-loss sharing (PLS) stipulates that the partners are free to determine the extent of their profit-sharing ratio regardless of their capital contributions, with the *Mudaraba* contract. (This is described in more detail in Chapter 2.) Losses, on the other hand, are to be shared strictly in proportion to their capital contributions. Collateral cannot be provided with PLS activities in the event that the project fails due to business risk. So in the event of the project failing the Islamic bank is exposed to financial loss. This results in Islamic banks being subject to asymmetric risk.

To ensure timely payment of the loan plus the institution's share of the profits (if any), a fine could be imposed on those borrowers who do not pay on time. To conform with the principles of the *Sharia'a* these fines must be deposited with a charity, rather than being given to individual financial institutions. So if the borrower defaults there is no explicit protection for the bank. Again this is asymmetric risk.

Adverse selection refers to the possibility that potential borrowers who are the most likely to produce an undesirable outcome are the ones who more actively seek out a loan, and are thus the most likely to be selected. Moral hazard occurs when the borrower engages in activities undesirable from the lender's perspective, after the loan has been granted.

Since the profit-and-loss sharing mechanism emphasises distribution of both risk and profits between the lender and the borrower when a loan is made, the lending institution should, in an ideal world, need only worry about the profitability of the proposed project for which the loan is requested rather than

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the creditworthiness of the firm to which they are lending. This should lead to more conservative decisions being made by the lender and to the need for more careful monitoring of the borrower.

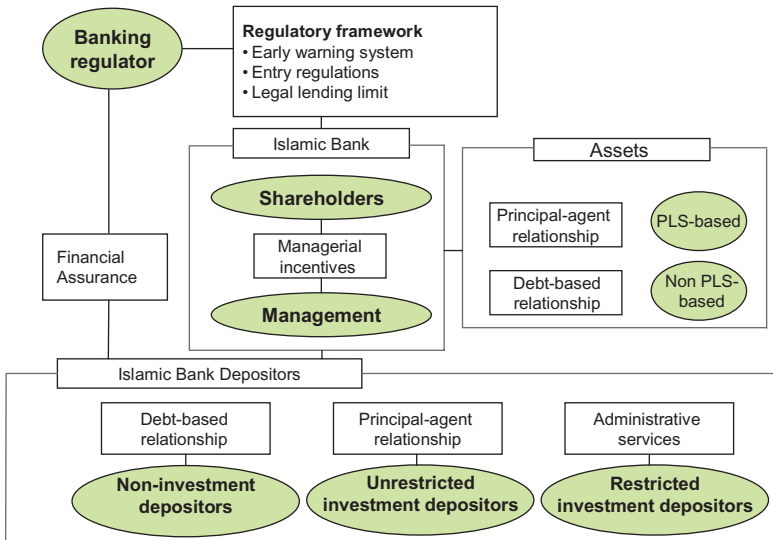
In the conventional banking model bank regulation and the availability of deposit insurance have replaced the need for monitoring bank activities by depositors.

Consequently, as far as small depositors are concerned, deposits in one bank are very similar to deposits in another bank, and hence there is less need to monitor bank activities.

The Islamic, interest-free system, on the other hand, imposes the burden on depositors of gathering information about the safety, soundness, riskiness, and profitability of the bank. Again asymmetric risk is a problem. *Figure 1.1* illustrates the relationships within an Islamic banking system.

Figure 1.1. Relationships within an Islamic banking system

Source: Dar, H.A. and J.R. Presley (1999), "Islamic finance: a Western perspective", *International Journal of Financial Services*.



*Riba in the Qur'an and Sunnah/hadith*

The Islamic prohibition of interest (*riba*) is so central to the Islamic banking system that it is essential to understand why this is and what the implications are.

Riba is of two major kinds:

1. **Riba Al-Nasiah** – *Interest on borrowed money.*
2. **Riba Al-Fadl** – *Taking a superior thing of the same kind of goods by giving more of the same kind of goods of inferior quality, e.g. dates of superior quality for dates of inferior quality.*

The literal meaning of interest or *riba*, as it is used in Arabic, means an excess or increase. In the Islamic terminology interest means effortless profit. *Riba* has been described as a loan with the condition that the borrower will return to the lender more than the amount borrowed.

One of the main concerns of Muslims, when it comes to financial transactions, is to avoid *riba* in any of its forms. This is despite the fact that the basic foundation of modern business and finance involves interest-based transactions.

The Prophet Mohammed foretold of a time when the spread of *riba* would be so overwhelming that it would be extremely difficult for Muslims to avoid it. This situation calls for Muslims to be extra cautious before deciding on what financial methods to use in any personal or business transaction.

To understand why the ban on interest is so central to Islamic finance it is necessary to examine the textual evidence.

*What is the textual evidence for the ban on interest?**The Qur'an – Al-Baqarah Surah 275–281*

275. Those who eat Riba will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitān (Satan) leading him to insanity. That is because they say: "Trading is only like Riba," whereas Allah has permitted trading and forbidden Riba. So whoever receives an admonition from his Lord and stops eating Riba shall not be punished for the past; his case is for Allah (to judge); but whoever returns [to Riba], such are the dwellers of the Fire – they will abide therein.

The Prophet Mohammed foretold of a time when the spread of riba would be so overwhelming that it would be extremely difficult for Muslims to avoid it





276. Allah will destroy Riba and will give increase for Sadaqât (deeds of charity, alms, etc.) And Allah likes not the disbelievers, sinners.

277. Truly those who believe, and do deeds of righteousness, and perform As-Salat (Prayer), and give Zakat (an obligatory religious tax), they will have their reward with their Lord. On them shall be no fear, nor shall they grieve.

278. O you who believe! Be afraid of Allah and give up what remains (due to you) from Riba (from now onward), if you are (really) believers.

279. And if you do not do it, then take a notice of war from Allah and His Messenger but if you repent, you shall have your capital sums. Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums).

280. And if the debtor is in a hard time (i.e. has no money), then grant him time till it is easy for him to repay, but if you remit it by way of charity, that is better for you if you did but know.

281. And be afraid of the Day when you shall be brought back to Allah. Then every person shall be paid what he earned, and they shall not be dealt with unjustly.

The Qur'an – Al-Imran Sura 3:130

O you who believe! Eat not Riba doubled and multiplied, but fear Allah that you may be successful.

Hadith – Sahih Bukhari, Volume 3, No. 299; Narrated by 'Aun bin Abu Juhaifah, r.a.

My father bought a slave who practised the profession of cupping (*defined below*). My father broke the servant's instruments of cupping. I asked my father why he had done so. He replied, "The Prophet forbade the acceptance of the price of a dog or blood, and also forbade the profession of tattooing, or getting tattooed and receiving or giving Riba, and cursed the picture makers."

(Cupping means letting out bad blood that lies just beneath the skin. It is a kind of medical treatment.)

Hadith – Sahih Bukhari, 2.468, Narrated by Samura bin Jundab, r.a.

He speaks of in a dream related to the Prophet that there is a river of blood and a man was in it, and another man was standing at its bank with stones in front of him, facing the man





standing in the river. Whenever the man in the river wanted to come out, the other one threw a stone at his mouth and caused him to retreat back into his original position. The Prophet was told that these people, in this river of blood, were people who dealt in Riba.

Hadith – Mishkat-ul-Masabih

The following three ahadith have been taken from *Mishkat-ul-Masabih* under the section of interest. The English translation has been taken from its English version written by Al Hajj Moulana Fazl Karim (218–227 vol.11).

- Hazrat Jabir has reported that the Messenger of Allah cursed the devourer of usury, its payer, its scribe and its two witnesses. He also said that they were equal (in sin).
- Hazrat Abu Hurairah reported that the Prophet said: A time will certainly come over the people when none will remain who will not devour usury. If he does not devour it, its vapour will overtake him. [Ahmed, Abu Dawood, Nisai, Ibn Majah]
- Hazrat Abu Hurairah reported that the Messenger of Allah said: I came across some people in the night in which I was taken to the heavens. Their stomachs were like houses wherein there were serpents, which could be seen from the front of the stomachs. I asked: O Gabriel! Who are these people? He replied these are those who devoured usury. [Ahmed, Ibn Majah]

Hadith – Hazrat Al-Khudri reported that the Prophet said: Gold in exchange for gold, silver in exchange for silver, wheat in exchange for wheat, barley in exchange for barley, dates in exchange for dates, salt in exchange for salt is in the same category and (should be exchanged) hand to hand, so whoever adds or demands increase he has practised usury. The giver and taker are the same.

Conclusion on the textual evidence

It is evident from the textual evidence that interest is *haram* (prohibited) for Muslims. Allah has declared war on the user. Islam encourages men to earn their own provision and provide for their families on condition that the earnings are in accord with the *Sharia'a*.

While the basic source of the ban on the use of interest is the divine authority of the Qur'an, somewhat surprisingly, no explicit rationale was provided for why this was the case. It is this issue to which I now turn.



What is the Islamic rationale for banning interest (riba)?

One of the main features that distinguishes Islamic financial institutions from their conventional banking counterparts is that Islamic institutions adhere closely to the Islamic creed (*aqidah*). Since those institutions are first and foremost Muslim institutions, they share the fundamental Islamic drive to avoid what Allah has forbidden. In this regard, the Qur'an contains clear and eternal prohibitions of all kinds of *riba*, whether sales or loan related.

In this context we read, as mentioned earlier: "But indeed Allah has permitted trade and forbidden *riba*" (Sura 2:275). The Qur'an also states that Allah has ordered Muslims to abandon and liquidate all remaining *riba* (regardless of how large or small): "O you who believe, fear Allah and give up what remains of *riba*, if you are indeed believers" (Sura 2:278), and declare war on those who devour it: "If you do not, take notice of a war from Allah and his Messenger; but if you turn back then you shall have your principals without inflicting or receiving injustice" (Sura 2:279).

To deserve such a declaration of war is the severest punishment in all of Islam, providing further proof that *riba* is one of the most severely forbidden of transgressions.

There is no ambiguity about the impermissibility of riba within the Islamic financial system

The primary rationale for abolishing interest and for introducing Islamic banking principles is a religious one, and it is therefore difficult to evaluate the reasoning in purely secular terms. Nevertheless, Islamic scholars have sought to provide a theoretical basis for the prohibition in terms of morality and economics.

Five reasons have been put forward, by Islamic scholars, for the prohibition of *riba*:

1. *It is unjust.*
2. *It corrupts society.*



3. *It implies improper appropriation of other people's property.*
4. *Ultimately it results in negative economic growth.*
5. *It demeans and diminishes human personality.*

1. Interest is unjust

Among the most important reasons that have been emphasised by most Islamic scholars is that interest is prohibited because it is unjust (*zulm*). A contract based on interest involves injustice to one of the parties, sometimes to the lender and sometimes to the borrower.

Sura 2:279 clearly states that taking an amount in excess of the principal would be unjust. It also recognises the right of the lender/creditor to the principal without any decrease as that too would be unjust. The Qur'an does not rationalise, however, as to why it is unfair to take an excess in the case of a loan. Presumably it relies on the notions of equality and reciprocity inherent in the Islamic concept of justice.

The unacceptability of injustice and unfairness was never in dispute between the Qur'an and its audience. What is not immediately understandable, to non-Muslims, is the Qur'anic stand that taking anything in excess of the principal amounts to injustice.

The *riba* contract is deemed to be unjust to the borrower because if somebody takes a loan and uses it in his business he may earn a profit or he may end up with a loss. In the case of a loss the entrepreneur will have received no return for his time and work. In addition to this loss he has to pay interest and capital to the lender. The lender, or the financier, in spite of the fact that the business has ended up making a loss, gets his capital returned as well as his interest. It is in this context that *riba* is deemed unjust.

The Qur'an makes clear that individuals having difficulty paying their debts should have their obligations made easier for them and not more difficult. Such individuals may actually deserve charity and it is a morally offensive practice to



start demanding that they be punished for their failure to pay on time.

Riba, derived from this rationalisation in the Prophet's last sermon, is the crime of a party which is owed money demanding an 'increase in a debt' owed to them as a compensation for late payment. The reason for this delay may be that the lender has suffered some financial problem but, Islamic scholars argue, a judge must consider the debtor's situation first. If payment is late without good reason and there was no difficulty in making the payment, then demands of payment of additional damages may be legitimate, but this is a matter of judgement for a judge and it is not for one party to be able to impose their desired punishment on the other. Automatic penalties built into contracts are also unjust for the same reason. For damages to be legitimate, it is argued, they must be based on the claim of wilful breach of contract and decided by a judge. Failure to pay may be due to difficulty of circumstances and therefore, it is argued, not something simply willed by the debtor.

There are thus two related aspects to the practice of *riba* as referred to by the Prophet and the Qur'an that make it unjust:

1. *punishing someone for default is unjust; and*
2. *it should be a judge who decides what any compensation should be for a default, not the party to whom the debt is owed.*

The latter aspect is crucial, it is argued, because once a jurisdiction allows for contracts to impose punishments for default, then the law itself becomes nothing but the slave of such contracts and any crime may be legitimised as a form of punishment of the 'debt-slave'. The relationship of one party imposing punishment on another is that of a master and slave. The relationship of one party buying something from another should be one of a relationship of equals.

2. *Interest corrupts society*

The argument here is that there is an association between charging interest with *fusad*, loosely translated as the corruption of

society. This argument is revealed from Sura 30, Ar-Rum, along with some of the preceding and following verses. These read:

"That which you give in usury in order that it may increase in other people's property has no increase with Allah; but that which you give in charity, seeking Allah's countenance, has increased manifold. Allah is He Who created you and then sustained you, then causes you to die, then gives life to you again. Is there any of your (so called) partners (of Allah) that does aught of that? Praised and exalted be He above what they associate with him. Corruption does appear on land and sea because of (the evil) which men's hands have done, that He may make them taste a part of that which they have done, in order that they may return." (Sura 30: 37–41).

Within the framework of the general message that *fasad* in society results from men's own (wrong) behaviour, we can clearly read the sub-message that charging interest is one of those facets of wrong behaviour that corrupt society. In fact this may have been the first time, chronologically speaking, that *riba* is mentioned in the Qur'an. It was in the fitness of things to highlight its negative social role long before the practice of charging interest was banned.

3. Interest implies unlawful appropriation of other people's property

The reasoning here is indicated in the verse from Sura 4, 'al-Nisa'. In that verse the Jews are admonished for "taking usury when they were forbidden it, and of their devouring people's wealth by false pretences" (Sura 4: 161). Significantly, the Qur'an relates the tendency to appropriate other people's wealth without any justification to some more serious crimes. In (Sura 9: 34) *riba* is associated with hoarding and (Sura 4: 29) seems to put it at par with murder.

Considering the serious dimensions of *fasad* to which *riba* has been related, the message seems to be clear: charging interest belongs to a mind-set that leads to the disruption of civil society.

The argument here is that interest on money is regarded as representing an unjustified creation of instantaneous property

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rights. It is unjustified, because interest is a property right claimed outside the legitimate framework of recognised property rights. It is instantaneous, because as soon as the contract for lending upon interest is concluded, a right to the borrower's property is created for the lender. This is what the provision of collateral is all about.

4. Ultimate effect of interest-based systems is negative growth

The fourth reason is implied in the declaration that *riba* is subject to destruction (*mahq*) (Sura 2: 276) which means decrease after decrease, a continuous process of diminishing. That sounds a little odd as it runs counter to the commonly observed fact of people growing rich by applying the power of compound interest. Once we leave out the improbable interpretation of individual wealth amassed through *riba* business being subject to continuous decrease, we have to turn to an alternative interpretation, namely to its effect on social wealth.

Riba, even when it is increasing in numerical terms, it is argued, fails to spur growth in social wealth. That role is played by charitable giving mentioned in the next half of Sura 2: 276. Charitable giving transfers purchasing power to the poor and the needy who are dependent upon it. The destination of interest earnings is not that certain.

Interest, it is argued, also has many adverse consequences for the economy. It results in an inefficient allocation of society's resources, and can contribute to the instability of the system. In an interest-based system the major criteria for the distribution of credit is the creditworthiness of the borrower. In an Islamic finance sharing system the productivity of the project is more important, thereby encouraging finance to go to more productive projects. In this way, instead of resources going to low-return projects for borrowers with better creditworthiness, bank lending is more likely to flow to high-return projects even if the creditworthiness of the borrower is somewhat lower. Therefore, it is argued, the Islamic sharing system is more efficient in allocating resources.

It is also deemed to be more efficient because the return to the bank is now linked to the success of the project. In the



interest-based system banks do not have to care as much about project evaluation, it is argued, since they obtain a return on their loans irrespective of the success of the project.

Also in conventional banking if security is provided then a return is guaranteed (or at least part guaranteed) even if the project is a disaster. While conventional banks, of course, make losses, the argument is that interest-based systems force borrowers to continue to repay loans even when their circumstances are ill-suited to making such repayments, ultimately exacerbating the problem and resulting in default. Interest-based banking systems, again it is argued, may accentuate downturns in the business cycle.

5. Interest demeans and diminishes human personality

The fifth reason behind the prohibition of *riba* is inferred from Sura 2: 275 quoted above. This verse draws a picture of ‘those who devour usury’ as well as stating the reason why they got into that pitiable mould, as Muslims would see it. That reason is their being trapped into the false economics that equates trade – the act of selling and buying – with the practice of charging interest.

In many cases, the charging of interest is also demeaning. For example, if the loan is for procuring things necessary for survival, charging interest violates the nature of social life which requires cooperation, care and help for the needy by those who can spare the money.

One may legitimately ask how earning interest can affect your personality? A plausible answer lies in the generally rising level of anxiety in modern interest-based societies. The fact of the matter is that in the complex modern economy the relationship between the one who pays interest and the one who receives interest is not as direct and visible as in the primitive agricultural societies or merchant communities of old. It is mediated by numerous agencies and institutions, which makes it impersonal, potentially raising anxiety levels.



