

THE PROHIBITION OF USURY (*RIBĀ*) A MORAL-ETHICAL PERSPECTIVE OF ISLAMIC FINANCIAL AND BANKING LAW: A COMPARATIVE STUDY BETWEEN THE ISLAMIC AND THE CONVENTIONAL MODEL*

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ABSTRACT

We live in a world which has for all practical purposes, abandoned religious foundations in its economic systems. In our troubled world – some of the gravest problems we face is global warming, a food crisis and poverty – there is a need to return to the Revelation of Harmony and human reason in our economic thinking. Both the socialist as well as the capitalist in the economic systems have proven their failure to ensure economic justice that serves to benefit all in the society, both the rich and the poor. In particular, capitalism is currently causing a terrifying scenario by making the rich richer and the poor poorer. In this context, the fundamental motivation for this research is to examine whether a Divinely inspired banking system could contribute to alleviating the global financial crisis that we are facing. In fact, it has been remarked that the Islamic economic system represents a via media between socialism

* This article is based on a research on Islamic banking and finance and was funded by the University of the Free State.

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and capitalism. Of course, the prohibition of interest/usury rests on an ethical foundation. It is necessary to reassert that this banking ethic is based on the avoidance of all form of financial exploitation and having as its principal objective to combine the purpose of wealth creation and poverty alleviation.

Keywords: *ribā, interest, mushārah, muḍārah, interest-free, capitalism, Islamic banking system*

INTRODUCTION

Islamic banking is a landmark in new paradigmatic thinking interrelating finance, economy, community and society. It has to operate according to the proper finance outlook for socio-economic development. Islamic banking must combine the goals of economic efficiency and social justice that complement each other. Such a model of socio-economic development is different from the financial, economic and social modes of the capitalist system. In line to actualize the well-being for all, Islamic banks ought to focus on both financing as well as development according to the tenets of the *Sharī'ah*. Islamic banks have done well in terms of their financial stability and popularity among clients. There is a rich premise for the principles of ethics and values emanating from Islam to be incorporated in the matters of money, finance and the economy.

HISTORY OF THE CRITIQUE OF USURY

Usury In Greek Thought

Taking interest in ancient Greek was a fact of life. By the end of the fifth century before Christ, banking was a growing concern in Athens. Most Greeks saw loans are made for commercial reasons and an element in the general prosperity.¹ Land and sea commerce provided expanding markets for the money lender's wares. The lender shared the increased productivity his loan has caused, especially when the money lent is risked in the process.² In the fifth century before Christ, banking was a growing concern in Athens and interest was commonly accepted. Aeschinus for example, kept his perfume-works in

¹ Maloney, R. P. (1971), "Usury in Greek, Roman and Rabbinic Thought," *Traditio*. New York: Fordham University Press, pp. 79-80

² Demosthenes, *In Pantaenetum*, pp. 53-54.

business by borrowing and Pantaenetos and Mantitheos ran mines with the help from the moneylenders.³ The ordinary rate of interest, paid on a monthly basis, amount to 12% a year. Mortgage and commercial loans were offered at 16% and 18%, while maritime loans had rates of 20%, 40%, 60% and even 100% depending on who the borrower is, the destination of the ships, and the political and economic situation. In case of shipwreck, the borrower owed nothing, neither interest nor principle. As a result the creditor ran an even greater risk than the debtor. This helps account for the high interest rates.⁴

While the legitimacy of interest-taking was generally recognized throughout Greek history, several strains of opposition, however, did exist. Plato and Aristotle, attacked usury as an unnatural means of acquiring money. Plato, like Aristotle, saw money as barren.⁵ In his *Leges*, Plato writes:

*“No one shall [...] lend at interest, since it is permissible for the borrower to refuse entirely to pay back either interest or principal.”*⁶

Aristotle places money-lending among the most despicable occupations. He lists the moneylender along with other unsavory characters: “The other sort of people are those who exceed in respect of getting, taking from every source and all they can; such are those who follow degrading trades, brothel keepers and all people of that sort, and petty usurers who lend money in small sums at a high rate of interest; all these takes from wrong sources, and more than their due.”⁷

Usury In Roman Thought

Romans, like Greeks, regarded loans at interest as a fact of life. But what was an element in the general prosperity of Greece brought misery and revolt to Rome. The Romans therefore, sought to remedy the plight of debtors through a whole series of varied enactments from the *Twelve Tables* to the *Codex Justinianus*. Of the *Twelve Tables*, the *Eight Tablet* took up the problem of exorbitant rates of interest: “[No] person shall practice usury at a rate of more than one-twelfth.”⁸ Although the 12% was the legal maximum in Rome in 51

³ Glotz G. (1926), *Ancient Greeks at Work*. New York, p. 241.

⁴ Maloney, R. P. (1971), *op.cit*, p. 80.

⁵ Plato (n.d), *Leges*, 11.921d.

⁶ *Ibid*, 5.742 (Loeb transl.)

⁷ Aristotle (n.d), *Ethica Nicomachea* 4.1.40 f. (Loeb transl.)

⁸ *XII Tab.* 818a (transl. Ancient Roman Statutes [n. 31] 11).

B.C., moneylenders like Verres lent at 24% and Brutus and his agents lent at 48%. High rates kept the greedy moneylender in public odium, but the taste of profit made odium easier to live with. Theodosius shows a distinct dislike for greedy creditors.⁹ Likewise Valentinian's *Novellae*, shows a similar disdain for creditors' greed.¹⁰ Exorbitant rates sowed seeds of discord. Popular uprisings resulted and the plebeians refused to fight in Roman wars unless something were done about the condition of debtors.¹¹

A very important reform Law put a ceiling on the accumulation of interest, so that it could not mount higher than the capital.¹² In 357 B.C., the *Lex Duillia Menenia*, reaffirmed the prescription of the *Twelve Tables*. The *Lex Licinia Sestia* reduced the debtor's burden by cutting his payments and spreading them out and a Law in 347 mentioned in Tacitus' *Annales*, has reduced the interest rate. Livy writes:

“[During] the consulship of Titus Torquatus and Gaius Plautius [...] the rate of interest was cut in half (*semiunciarium tantum ex uniciario fenus factum*)...”¹³

This left fertile ground for the assault on usury which the Church would mount following its Christianization of the Roman Empire. The Roman Catholic Church prohibited the taking of interest by the clergy by the fourth century AD. In the eight 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 reach its zenith in 1311 when Pope Clement V banned usury absolutely and declared all secular legislation in its favour, null and void.¹⁴ Despite numerous subsequent prohibitions by the Popes, loopholes in the Law were found and along with the growing tide of commercialization, the pro-usury counter-movement began to grow. The rise of Protestantism and its pro-capitalism

⁹ *Cod. Theod* (n.d), 4.19.1.

¹⁰ Valentinian (n.d), *Novella* 12 (transl. Pharr 526); Maloney, R. P. (1971), *op.cit*, p. 94.

¹¹ *Ibid*, p. 91.

¹² *Cod. Theod* (n.d), 4.19.2, Justinian (n.d), *Novellae* 121.

¹³ Livy (n.d), 7.27.3 (Loeb transl.)

¹⁴ http://www.alastairmcintosh.com/articles/1998_usury.htm, p. 2, 1 November 2007.

influence is also associated with this change.¹⁵

Usury In Rabbinical Thought

Jewish writers, like Philo and Josephus, and materials, like the *Mishna* and *Tosephia*, the *Siphra on Leviticus*, the *Siphre on Numbers* and *Deuteronomy*, and the *Mekiltha on Exodus*, provides insight into Jewish thought on usury.¹⁶

Talmudic legislation and the Old Testament discourage loans at interest. The Jew was to lend freely, asking no interest.¹⁷ This sentiment reverberates in the *Tosephia to Baba Mezi'a* (promise a reward to those who lend freely),¹⁸ the *Siphre on Deuteronomy* (not only is all interest forbidden, but anything that looks like interest),¹⁹ and in the *Mekiltha on Exodus* (condemns everybody who takes part in usury).²⁰

Many, however, broke the letter and the spirit of the Law.²¹ Interest taking still went on, for example, the permission to take interest from the gentiles, remained. The *Siphre on Deuteronomy* confirmed that the usury prohibition was one of those Laws which concerned only the members of the community. While the Law forbade “iron terms” toward Jews, it allowed them toward foreigners. This permission refers to the type of contract where A sells B a field or flock, B is demanded to share the profits from the field or flock until he has made full payment. B in the meantime bears the burden of all losses. In such a case, A’s security was like “iron.” But this was obviously usury in the broad sense of the rabbis because B is forced to give more than what he received. It is obvious that B is the owner of the field or flock since he bought it and borne the burden of all losses, unfortunately he is compelled to pay additional portion he makes. Nevertheless, such transaction is permitted only if B was a foreigner.²²

Strangely, interest taking is not absolutely forbidden among the Rabbis. In the *Tosephia to Baba Mezi'a*, for example, there is a prescription: “A man can

¹⁵ *Ibid.*

¹⁶ Maloney, R. P. (1971), *op.cit*, p. 96.

¹⁷ *Tosephia to Baba Mezi'a* (n.d), 6.18.

¹⁸ *Ibid*; Maloney, R. P. (1971), *op.cit*, p. 98.

¹⁹ *Siphre on Deuteronomy* (n.d), 262 (23.20); Maloney, R. P. (1971), *op.cit* p. 99.

²⁰ *Mekiltha on Exodus* (n.d), 3.149 (Ex. 22.24)

²¹ Philo (n.d), *De virtutibus*, pp. 86-87.

²² Maloney, R. P. (1971), *op.cit*, pp. 102-103.

borrow at interest from his wife and his sons only to let them know the taste of usury.”²³

Talmudic legislation and the Old Testament discouraged interest taking. It emphasized the obligation to lend freely to the poor. The permission to take interest from the gentiles remains intact. This notion is echoed in Deuteronomy 22: 20:

“Unto a stranger thou mayest lend upon usury; but onto thy brother thou shalt not lend upon usury [...]”

and Deuteronomy 23: 19:

“Thou shalt not lend upon usury to thy brother [...]”

Interest taking is provided in these few cases among Jews, so that the prohibition of interest was not absolute.

Usury In Islamic Thought

Islamic economic principles have existed since 622 AD - the year of *Hijra*.²⁴ The criticism of usury in Islam was well established during the Prophet Mohammed’s life and reinforced in his teachings based on the *Holy Qur’an* [ii] dating back to around 600 AD. In AD 605, just before the dawn of Islam, a spark of fire caught the curtains of *Ka’ba* (House of God in *Makkah*) resulting in serious damage to the building. For the repair and reconstruction of the building, contributions were asked from the general public. It was announced that for the Holy Building, only pure, clean and honestly earned money should be donated. Usurious people (and prostitutes) were specifically debarred from contributing. It is evident that even in these dark days of civilization, usury and interest were considered money earned by unethical means and is therefore rejected by Islam.²⁵

Usury (*Ribā*) And Interest In Islam: A Discourse

In the past, there has been dispute if *ribā* refers to interest or usury. This paper asserts that usury/*ribā* covers only “excessive” interest. In the *Holy Qur’an* (*Sura ii: 275*), footnote 324 (the commentary of A. Yusuf Ali), usury (*ribā*)

²³ *Tosephia to Baba Mezi’a* (n.d), 5.15.

²⁴ Hammad, A. E. (1989), *Islamic Banking: Theory and Practice*. USA: Zakat and Research Foundation, p. 4.

²⁵ Siddiqī, S. H. (1994), *Islamic Banking*. Pakistan: Royal Book Company, p. 3.

prohibition, include profiteering of all kinds, but exclude economic credit, the creature of modern banking and finance. That is because the Holy Qur'an says:

*"Trade is like usury, but God hath permitted trade and forbidden usury."*²⁶

In the context of "economic credit," it could refer to interest of profit. Hence, there is a difference between usury (*ribā*) and interest.

This paper is a result to the debate on appropriate interpretation of *ribā* (usury) and interest. There is, however, an ambivalence on the concept of usury (*ribā*) and interest, among Muslim scholars: One group is in the opinion that not all forms of interest is *ribā* (usury), where as the other group, (that) is of the opinion, that usury (*ribā*) covers all forms of interest and not only "excessive" interest.

With regards to the Qur'anic notion that God permitted trade, it is obvious that usury is not merely interest. In view of this, nominal interest, like bank interest, may not be regarded as *ribā*. Three caveats in favour of the differentiation between usury (*ribā*) and interest are as follows:

- a) *Ribā* means usury and as such interest, particularly bank interest, does not fall into the ambit of *ribā*.
- b) *Ribā* relates to loans contracted by the poor and the needy persons for consumption purposes, while interest constitutes reward on commercial, productive and profitable loans.
- c) Interest stands for reasonable rate of return, while *ribā* represents an excessive, exorbitant and exploitative rate of interest.²⁷

This paper asserts that interest is moderate and *ribā* exorbitant and oppressive. The prohibition of *ribā* is understood as relating to the exploitation of the economically disadvantaged in the community by the relatively affluent, it is also that this element of exploitation may or may not exist in modern bank interest.

²⁶ Ali, A. Y. (1387 A.H.-1967 C.E.), *The Holy Qur'an, Text, Translations and Commentary, Commemorating the 1400th Anniversary of the Holy Qur'an*. Durban: Universal Printing Works. Sarta J. Company. Sura ii; 275.

²⁷ Ahmad K. (1994), "Elimination of Riba: Concept and Problems," in *Elimination of Riba from the Economy*, Institute of Policy Studies. Lahore: Shirkat Press, pp. 38-39. According to Khursid Ahmad these three premises are incorrect and theoretically inadmissible in Islamic thought. He is of the opinion that there is no technical difference between interest and *ribā*.

On the strength hereof, *ribā*-based financial instruments, are forbidden in Islam and as such Islamic banking must evolve alternate instruments of financing, like *muḍārabah* (a type of profit sharing) and *mushārahah* (partnership), etc.²⁸ With regards to these Islamic-based instruments of financing, the Islamic ban on *ribā* is not exactly parallel to “excessive” interest rate of Western economies, for the reason that depositors may still receive a return on their savings in the form of profit. Profit, therefore means, that there will be a positive nominal return on savings, but this rate of return is subjected to uncertainty.²⁹

The term *ribā* in Islam, covers therefore only “excessive” interest. This is indicative thereof that an Islamic banking system is one in which a payment or receipt of “excessive” interest will be forbidden.³⁰ As far as Islamic banking and finance is concern, there is no technical difference between “excessive” interest and usury. The rationale in Islam; “excessive” interest and usury (*ribā*) are the same.

ISLAM AS VIA MEDIA BETWEEN CAPITALISM AND COMMUNISM

An Islamic economic system would achieve a greater degree of economic justice than existing capitalist and socialist systems. An Islamic system is free from the exploitation and severe inequalities characterized in capitalism, whereas, there is a class that struggle the hallmark of socialism/communism.³¹

For a society to achieve economic justice, it must conform to the general principles of equality and fairness. Based on these principles, a society would not be considered purely Islamic if it allows (as in the case of capitalism) some of its members to live in luxury, while others are subjected to an impoverished existence. Individuals are to make charitable donations to those in need. The proceeds of the redistribution scheme known as *zakāt* (wealth tax), is used to aid disadvantaged members of society, the poor, the handicapped, the

²⁸ Yousefi M. et al (1995), “Islamic Banking and Friedman’s Rule”, *Review of Social Economy*, Vol. 53, No. 1, Spring, p. 68.

²⁹ *Ibid*, pp. 68, 74.

³⁰ Ahmad K. (1994), *op.cit*, pp. 37-38.

³¹ Kuran T. (1989), “On the notion of Economic Justice in Contemporary Islamic Thought,” *International Journal of Middle East Studies*, Vol. 21, No. 2 (May, 1989), p. 171, <http://www.jstor.org>

unemployed and orphans, etc. *Zakāt* seems to be a powerful instrument for bringing an economy in line with equality and fairness.³² The principles of equality and fairness, serve as offsets of justice.³³

In Islamic Law, spirit holds precedence over letter. Due to this Divine Legislation, Islam strives to break the stranglehold, which the vicious capitalist system has on the world economic order. The elimination of the capitalist system is the *sine qua non* (means literally without, in this context it implies the removal of the capitalist system, in order to reach a healthy (Islam) society) of building up a healthy Islam society. Islam opposes capitalism and communism (socialism).

In fighting the evils of capitalism, communism deals with natural issue only. Islam approaches the matter from the comprehensive perspective, as it deals with the natural as well as both religious and moral aspects of the issue. Whilst the communist champions the cause of the proletariat, Islam fights for the real interest of the entire humanity including that of the capitalist. The struggle of the communist has a selfish motive, but the struggle of Islam is the establishment of God's Law.³⁴ Under capitalism, if a loan is not paid on time, a penalty is levied to an extent where the borrower could end up paying double the principal. Such practice was traditionally dictated by the economic forces of the *jāhiliyyah* (pre-Islamic) society. The rule *caveat emptor* (literally beware of the stipulations of the buyer/purchaser), which sided the lender, also dictated that the amount of money would be assumed to be paid back on a due date with a very exorbitant compounded interest. If there was a delay in the payment, a penalty could easily be equivalent to the principal. Such severe and grossly exaggerated charges proof of exploitation and usury.³⁵

Islam emphasize that a person who earns profit at the expense of another is a blood-sucker, who will in the long run pave the way for his own destruction. The hoarding of wealth under a capitalist system will stop the circulation of money and creates imbalance in its distribution. The Holy *Qur'ān* states:

“And let not those who covetously withhold the gifts from God from His Grace, that it is good for them. Nay, it will be worse for them. Soon shall

³² *Ibid*, pp. 172-173.

³³ *Ibid*, pp. 181-182.

³⁴ Siddiqī, M. I. (1986), *Model of an Islamic Bank*. Lahore, Pakistan: Kazi Publications, p. 20.

³⁵ Hammad, A. E. (1989), *op.cit*, pp. 14-15.

the things which they covetously withheld be tied to their necks like a twisted collar, on Judgment Day."³⁶

The practice of hoarding wealth and its investment in usurious bank accounts, lie at the root of capitalism. Islam disproves of hoarding of surplus wealth.³⁷ The capitalist believes that spending impoverishes him, while Islam inculcates the belief that spending promotes individual and social prosperity.

*"The Evil One threatens you with poverty and bids you to conduct unseemly. God promise you His forgiveness and bounties."*³⁸

The capitalist considers spending a dead loss, but Islam believes that it is a productive investment.

*"Whatever of good you give benefits your soul, and you shall only do so for seeking the "face" of God. Whatever good you give, shall be rendered back to you. And you shall not be dealt with unjustly."*³⁹

The capitalist doctrine holds that hoarded wealth when lent out on interest, bring in more wealth. Islam differs and stresses that the practice of usury usually decreases wealth:

*"God will deprive usury of all blessings, but will give increase for deeds of charity"*⁴⁰

*"That which you lay out for increase through the property of other people, will have no increase with God. But that which you lay out for charity, seeking the countenance of God (will increase). It is these who will get a recompense multiplied."*⁴¹

The Islamic doctrine presents a complete anti-thesis to capitalism and communism. It believes that the hoarding of wealth and lending on interest concentrate in the hands of few individuals. The result is that the purchasing power of the mass declines daily and industry, trade and agriculture will fall

³⁶ Ali, A. Y. (1387 AH-1967 CE), *"The Holy Qur'an. Text, Translations and Commentary, Commemorating the 1400th Anniversary of the Holy Qur'an"*. Durban: Universal Printing Works, Sarta J. Company, p. 170; *Holy Qur'an*, Sura iii: 180.

³⁷ *Ibid*, Sura ii: 219, iv: 36, ii: 19.

³⁸ *Ibid*, Sura ii: 268.

³⁹ *Ibid*, Sura ii: 272.

⁴⁰ *Ibid*, Sura ii: 276.

⁴¹ *Ibid*, Sura xxx: 39.

into a depression state. The national economy will reach a breaking point and eventually all avenues of productive investment of hoarded wealth are closed on the capitalist themselves. The observation that usury acts as a mechanism by which the rich get richer and the poor poorer, is common to capitalism. Islam rejects capitalism on the basis that it contradicts the Principle of Distributive Equity. Capitalism technically works against the individual constitutional rights where money is a government service to which the public should have equal access. It stands to be condemned as a tool of tyranny. It is argued from an Islamic perspective, that the greatest problem in the capitalist economy is that of the crisis and interest play a peculiar part in bringing about the crisis. Compounded growth of interest may in fact, cause inflation.⁴² The Islamic economy would be free of the economic injustice that is allegedly rampant in capitalist and socialist economies.

RELIGIOUS FOUNDATION OF ISLAM

Muhammad Iqbāl Siddīqī, in his book, *Model of an Islamic Bank*, that capital has no right to assume the form of debt and a fixed interest rate regardless of whether the workers or management of a monetary institution gains any profit or otherwise.⁴³ He argues that the creditor does not concern himself with the profit or loss within the stipulated period or with the profit rate. He receives a fixed rate of profit month after month or year after year and yet retains claim to the capital.⁴⁴ In this usurious transaction, the creditor secures a definite amount of money for his loan but all that the debtor gets is the time to use the money in which time does not necessarily procure him profit. The creditor's demand for interest is recurrent until the principal amount is settled. The debtor spends the amount borrowed and has to return it with an addition by way of being charged the interest.⁴⁵ It is this injustice that Islam wants to abolish. Islam stresses that only in trade, professions and crafts, can a person earn profit after undergoing labor, hardship or by his skill or art. Muhammad Iqbāl Siddīqī writes:

“It is, however, clear that capital by itself cannot produce profit. It

⁴² http://www.alastairmcintosh.com/articles/1998_usury.htm, p. 5, 11 November 2007.

⁴³ Siddīqī, M. I. (1986), *op.cit.*, p. 13.

⁴⁴ *Ibid*, p. 14.

⁴⁵ *Ibid*, pp. 32-33.

yields profit only when human labor and intelligence are added to it."⁴⁶

And again:

*"[...] even human labor and intelligence do not bear fruit instantly. The combined power of capital, human labor and intelligence produces profit only after a certain period of time."*⁴⁷

Islam is adamant to ensure that without labor, hardship or skill (and time), gaining profit is unethical to Islamic perceptions.⁴⁸

The rule of Islam is simple: If you advance a loan, you are entitled to receive your capital only and nothing more.⁴⁹ If you wish to secure profit, you should enter into a partnership and become a shareholder. Islam enjoins a partner to invest his capital in agriculture, trade or industry on the condition that the profit shall be divided between him and the entrepreneur. What is the obstacle to completely abolish interest and enforce an alternative interest-free approach? The profit accounts can easily be kept as interest accounts. Interest can be justified in Islam only if it resulted in reinvestment.⁵⁰

Any transaction conducted between people is usually done with the intent to maximize profit and fully utilize sources. This concept is considered obsolete in any economic system, except for in Islam where the heart of its economic system is seen through the perspective of the relationship to God and to the Word of God. The realization of an economic return would be a reflection of a relative materialism. Being fair is essence and taking into account the safeguard so as not to allow others to gain unjustly. The Prophet Muhammad says:

*"Worship God as if you see Him, if you do not, He does."*⁵¹

Such a statement is a clear expression of the philosophy used when dealing among humans, be it spiritual, personal or business transaction. It would be judicious if everyone is mindful of this, when attending to any business, God sees us, even if we do not see Him. Acceptance to this would likely produce honest and just transactions. There is a significant and beneficial impact on any

⁴⁶ *Ibid*, p. 35.

⁴⁷ *Ibid*, p. 35.

⁴⁸ *Ibid*, p. 33.

⁴⁹ *Ibid*, p. 14.

⁵⁰ Van Greuning H. & Siddīqī, M. I. (2008), *Risk Analysis for Islamic Banks*. Washington, DC: The World Bank, p. 8.

⁵¹ Hammad, A. E. (1989), *op.cit*, p. 11.

economy and thereby produce an economic balance.⁵²

Social Justice

Social justice in Islamic economy encompasses the principle that any transaction leading to injustice and exploitation is to be prohibited. According to this principle, a financial transaction should not lead to the exploitation of any party related to the transaction.⁵³

It is clear that the Islamic paradigm with regards to social justice, incorporates a spiritual and moral framework that value human relations above material possessions. In this way, it establishes a balance between material and the spiritual fulfillment of human beings, thus creating a balance relationship between the individual and society. As opposed to the conventional model, individual and the society are independent. The Islamic model does not deny the self-interest and private gains of the individuals. They are rather regulated towards the betterment of the collectivity. The *Sharī'ah* provides a network of ethical and moral rules for all participants in the market and requires that these norms and rules to be adhered by all.⁵⁴

On the basis of social justice, Islam condemns particularly the injustice of a lender being guaranteed a positive return without assuming the risk factors with the borrower. The money lender merely funds and does not invest his time or labor in the business but is guaranteed a fixed rate of profit in the form of interest. Islam says that the lender is unjustified by earning a fixed rate of profit. It stipulates that interest charges on loans, culminates into exploitation. Reason being, borrowers, especially the small ones are in a weaker position.⁵⁵ Interest charges render the full adjustment of loans almost impossible and the poor person continues taking one loan after another to get out of the vicious circle unsuccessfully. Although he has already paid much more than the original amount, the outstanding amount continues to rise due to the interest. This will result to the miserable person (debtors) unable to meet basic needs and that of their families, leading to poor health, sub-standard living conditions and no education.⁵⁶

⁵² *Ibid*, pp. 11-12.

⁵³ Van Greuning H. & Siddīqī, M. I. (2008), *op.cit*, p. 7.

⁵⁴ *Ibid*, p. 6.

⁵⁵ Siddīqī, S. H. (1994), *op.cit*, p. 25.

⁵⁶ *Ibid*, p. 26.

This sad state is highlighted by the British media in the case of David Taylor, who was a leukemia patient. He took up a loan from a major western bank. The bank overdraft grew at a frightening rate due to the high interest rate imposed by the bank. The poor sick man was worried that the longer he lived, the more of his life assurance money would be grabbed by the bank, leaving nothing or little for his family. Every additional day of his life meant less money for his wife and children. He was, therefore, not interested to prolong his life. This explains the misery caused by charging interest on personal consumption loans. Since there is no income for personal consumption loans, Islam has laid down that only the principal amount should be recovered provided the borrower is in the position to repay. It is based on this moral and economic logic that Islam prohibits interest in all form resulting its followers to desist from indulging in interest transactions.⁵⁷

Both developed and underdeveloped countries that depend on foreign long-term loans are unable to repay the installments of interest and principal amount, due to poor economic conditions. A parallel argument relates to the devastating social impact of the so-called "Third World debt crisis," a situation which even Pope John Paul II (1989) acknowledges in his *Sollicitudo Rei Socialis* when he states: "Capital needed by the debtor nations is to improve their standard of living now has to be used for interest payments on their debts."⁵⁸ A loan, for example, of \$100 at 10 percent per annum simple interest in 100 years comes to \$1100 only, whereas at compound interest rate of interest, it becomes \$1.378 million. The high interest rate (in the latter case) under the capitalist system can be equated a form of slavery.⁵⁹ Similarly, rich countries have provided financing to underdeveloped countries as long-term loans at nominal rates of return. These poor countries such as Pakistan, India, Bangladesh, Mexico, Brazil, Argentine and the Phillipine's economic growth is very slow, as the burden of payment of interest eats away a substantial portion of their revenues. These countries also feel the debt pinch and interest in repayments. Viable solutions to the world debt problem are either a write-off (French President Mitterrand reportedly proposed in June 1988 that one-third of low-income debt should be written off) or convert to some kind of equity (a large market in "debt-equity swaps" has already developed and is growing rapidly). Debt-equity conversion, proposed by Islam, is used by countries facing foreign debt problems. It requires the debtor country to allow a foreign investor to purchase its debt from the creditor at a discount and convert it into local currency for

⁵⁷ *Ibid*, pp. 26-27.

⁵⁸ [http://www.alastairmcintosh.com/articles/1998 usury.htm](http://www.alastairmcintosh.com/articles/1998%20usury.htm), p. 4.

⁵⁹ Siddīqui, S. H. (1994), *op.cit*, p. 27.

purchasing a local equity-based asset. The creditor is willing to sell the debt at a discount thus allowing the investor to obtain a discount on the purchase of the local currency.⁶⁰

It can be argued that even the richest country of the West is groaning the mountains of debts. The US for example, is the most indebted country today. Its domestic debt has crossed the limit of \$3 trillion with annual interest payments coming to \$290 billion. This debt mountain has grown in the 20th century, as in the year 1901, America's total debt was only \$1 billion. Khurshid Ahmad argues that international financial dealings should not be on the basis of interest-based loans. What happens when a Muslim individual firm or state find it totally unavoidable to deal with foreigners, individuals or corporate bodies, that refuse to deal based on Islamic terms and conditions? Khurshid Ahmad believes that under the Law of Necessity for a certain specified transitional period, transactions involving interest, may be condoned or tolerated. He unwittingly echoes Nawazish Ali Zaidi's sentiments, when the latter says that banks operate to the Law of the land they are located. This means that American, British or Japanese banks operating in Pakistan, have to transact business according to the rules and regulations enforced in Pakistan. Likewise, Pakistani banks located in foreign countries have to transact their business according to rules and regulations applicable within. As a result, Pakistan bank branches of Pakistan in most foreign countries will operate on the basis of interest. As mentioned earlier, Islam condemns interest and to take interest-income is unethical in Islam. What should the Pakistani banks do then? Zaidi propounds that the interest portion earned by foreign branches of Pakistani banks be surrendered for charitable purposes so that it is not included in the dividend income distributed to the shareholders of Pakistani banks.⁶¹ On the same note, Khurshid Ahmad, stresses that *iztirār* cannot be used as an excuse to open the floodgate of interest-based relations with the outside world. The question of international transactions, commercial as well as financial, has

⁶⁰ Ahmad K. (1994), *op.cit*, p. 59.

⁶¹ Zaidi, N. A. (1994), "Riba-Free Alternatives in Commercial Banking," in *Elimination of Riba from the Economy*. Institute of Policy Studies. Lahore: Shirkat Press, pp. 100-101; Wilson R. (1999), "Challenges and Opportunities for Islamic Banking and Finance in the West: The United Kingdom Experience". *Thunderbird International Business Review*, vol. 41(4/5) pp. 421-444: p. 429. Holders of current accounts often earn very low rates of nominal interest in the United Kingdom, typically more than one percent below the rate of inflation. Nevertheless many British Muslims give this income to charitable causes, as the only means they have to purify their transactions accounts.

to be re-examined in great depth and sensitivity. He argues further that the focus is put on domestic economic issues and not the international financial transactions and capital movements.⁶² It triggers the idea of the Self-Reliance Act, which took effect on July 1, 1991. Under this Act, the government as well as private persons, are countenance not to contract interest-based debts.⁶³ The practice of doing banking on a non-interest basis has now come of age.

In spite the Self-Reliance Act, there is considerable evidence that foreigners will deal with Muslims on a non-interest basis.⁶⁴ Khurshid Ahmad cites a report (No. IFC/P-887, dated December 22, 1987 to the board of directors of the International Finance Corporation (IFC): “A change to Islamic modes of financing has been considered by IFC [...],”⁶⁵ and “The interest of foreigners in Islamic financing methods is also reflected in the amount or research that the International Monetary Fund is currently undertaking in this area.”⁶⁶

As an alternative to the Western interest-based loans, Khurshid Ahmad advises in favor of risk-sharing deals. He mentioned, that Turkey, has promoted the entire Bosphorus Bridge Project (around \$1 billion) on the basis of participatory capital as against interest-based loans.⁶⁷

ISLAMIC INSTRUMENTS OF FINANCING: AN ALTERNATIVE TO CONVENTIONAL FINANCE AND BANKING

***Muḍārabah* (Profit-Sharing)**

Modern capitalistic system is based on the institution of debt. Islam on the other hand allows loan-giving and loan-taking on ethical and philanthropic grounds. This is based on risk-sharing and consequently profit-and-loss-sharing. Any reorganization of conventional banking in favor for interest-free banking will have to be done on the basis of *muḍārabah* (profit-sharing). Herein, the evils associated with interest-based banking, can be prohibited. The Prophet of Islam (pbuh) approves this business methodology (*muḍārabah*). He adopted

⁶² Ahmad K. (1994), *op.cit*, p. 48.

⁶³ *Ibid*, p. 55.

⁶⁴ *Ibid*, pp. 58-59.

⁶⁵ *Ibid*, p. 58.

⁶⁶ *Ibid*, p. 59.

⁶⁷ *Ibid*, p. 51.

a few of them. It is reported that a man came to the Prophet and said: “I work at the market and my partner engages himself in prayers in the mosque.” The Prophet remarked: “Probably the prosperity of your business is due to this fact.”⁶⁸ Ibn Majah reports the Prophet to have remarked: “Prosperity lies in *muḍārabah*.”⁶⁹

It is necessary to use this method in the interests of human welfare. It often happens that a person possesses capital but is unable to engage in business vice versa. It is possible through *muḍārabah* for both of these parties to attain a common objective via mutual co-operation. In *muḍārabah*, one party provides capital and the other utilizes it for business purposes under the agreement that profit from the business will be shared according to a specified proportion.⁷⁰ This method is useful for all and is pivotal in the scheme of interest-free banking.⁷¹

In terms of the *muḍārabah* contract, the working party shares in the profit but is not liable for any loss. The working partner engages in business enterprises in view to augmenting the capital by way of profit, in return get a share of the profits. Should he fail to add to the capital, his efforts are wasted and he does not gain any profit. This is his loss. The *Sharī’ah* does not consider loss as a consequence of business effort. It views loss as a diminution of capital.⁷² Loss is made up of profit deducted from the original capital.⁷³ Where there is both profit and loss in business, loss is to be deducted from the profit.

⁶⁸ Siddīqī, N. S. (1985), *Partnership and Profit-Sharing in Islamic Law*. Leicester, UK: The Islamic Foundation, p. 13.

⁶⁹ *Ibid*, p. 13.

⁷⁰ *Ibid*, p. 15.

⁷¹ *Ibid*, p. 14.

⁷² *Ibid*, p. 27.

⁷³ *Ibid*, p. 33. “When there is a loss, it is to be made up out of profit and whatever of profit remains is to be distributed among the parties according to the mutually-agreed conditions. But this will hold good only when the original capital has been repossessed from the working partner. If the capital-owner repossess his investment with a loss, and then again gives it to the working partner, the (earlier) loss of it will not be made up out of (subsequent) profits because this will now constitute a fresh *muḍārabah* agreement.”

Mushārahah

Those capital-owners who cannot engage in business, will not be able to find working partners. Businessmen who have the ability to run a manufacturing business but lack of capital will not be able to secure it hence capital-owners, businessmen and ordinary people will have to suffer from unemployment, depression in economic activities and scarcity of manufactured goods, resulting in general hardship. In line to remove this general hardship, it is necessary that *mushārahah* is also considered legitimate objectives of *Sharī'ah* with an exception to *muḍārahah*. Besides *muḍārahah*, there are also other methods that are customary among businessmen and the working partner that can also be adopted. There are various types of of customary, for the purpose of this study we will mention one, namely *mushārahah* (partnership). Saad Al-Harran defines *mushārahah* as sharing, and states that it is a joint enterprise in which all the partners share the profit or loss in the joint venture.⁷⁴

The difference between *mushārahah* and *muḍārahah*, is that when the partner offers his labor/skill only (without any contribution in cash or in kind) this would be *muḍārahah* whereas for *mushārahah*, the partner (is obliged to) gives some contribution in cash or in kind. Another difference is, in case of loss; the loss is shared in *mushārahah* by both partners, while in *muḍārahah* it is wholly borne by the financier.⁷⁵

In lieu of these differences, it would be obvious that *mushārahah* best suits small enterprises. *Mushārahah* can be implemented in the context of modern business and trade. Al-Harran illuminates this implementation in the context of the agricultural set-up in Sudan. Although we live in an age of small due to rigid conditions set by institutions in collateral requirements, financing do not reach grassroots people who have the entrepreneurial ideas, lacking credit access. One exceptional case is the Sudanese Islamic Bank (SIB), which created a micro credit window, to financially assist rural farmers, rural women, craftsmen, artisans and small entrepreneurs both in the rural and urban centers.⁷⁶ Since farmers lose a lot by marketing their crops at harvest time when prices are normally at their lowest, the SIB was found to be a good business partner by the farmer. SIB pays the farmer 50 percent of the price prevailing at the time of the harvest and the crop is then stored under dual control by both the

⁷⁴ Al-Harran S. (1999), "Introduction: Cases in Islamic Finance," *Arab Law Quarterly*, vol. 14, no. 3, p. 194.

⁷⁵ *Ibid*, p. 198.

⁷⁶ *Ibid*, p. 194.

farmer and the bank. It also pays all transportation costs and storage, and when the crop is sold at a time when it command a higher price, the farmer gets 50 percent of the net profit for management, and the remaining net profit is divided equally between the bank and the farmer. The SIB played a vital role in providing finance for poultry production projects involving poor families. By providing Management advice through regular visits to these families, contributed the success of the programme.⁷⁷

This experience proved that *mushārah* financing is relevant and capable of bringing benefits to rural community, especially women and small scale farmers. *Mushārah* financing can provide a reasonable return of investment to both parties (bank and small scale farmer) and can lead the way to a self-sustaining banking system. Herewith, *mushārah* is viewed as a preferred model for interest-free financing as opposed to other financing methods such as *murābahah* (mark-up), installment sales and *ijārah* (leasing).⁷⁸

Mushārah, has undoubtedly created a healthy environment for small entrepreneurs to operate successfully in the economy. As the business world undergoes massive and fundamental change, thus raising competition to meet the quality, innovation, productivity and consumer value standards, there is an urgent need to assist small and medium sized industry entrepreneurs in the Muslim world and elsewhere. There is also a need to train students and others in project financing to produce more entrepreneurs. The outcome will be a widespread use of partnership shares throughout the banking system in the country. This will lead to a greater incentive to Islamic banks to provide investment financing for industrial and agricultural projects.⁷⁹

CONCLUSION

Islam does not stop at mere moral condemning of usury, but arouses aversion to it by proscribing it from a religious point of view. Wherever Islam holds sway, it imposes a legal ban on interest and declares all usurious contracts as invalid. Unlike the conventional system, Islam reforms the character of people towards inclination to usurious businesses and replaced by a spirit of sympathy and generous co-operation in human society.

In a usurious society (Western conventional banking society), the individual is exhorted. As a result, the chances of developing trade and industry diminish

⁷⁷ *Ibid*, p. 195.

⁷⁸ *Ibid*, p. 196.

⁷⁹ *Ibid*, p. 200.

and opportunities of capital formation become scarce. The rise in the capital holdings of a few individuals (under capitalism) will cause depression in the economy collectively. In a capitalist system, one individual enhances his accumulated wealth by depriving thousands of individuals and incapable of earning anything, let alone saving. In the contrary, when the interest rate is zero, the state guarantees relief to every citizen in need, hence stinginess and hoarding of wealth will vanish. The affluent citizens will spend freely and pass on enough purchasing power to the poor citizens. This will promote trade and industry under *muḍārabah* and *mushārah*, which will open up more employment opportunities, as in the case study of the Sudanese Islamic Bank. The majority of the people can save from the enhanced income. This saving will not arise out of stinginess, apprehension or greed, it is the product of an economic system by which the affluent will still be left with much surplus wealth as they will not find any needy person to whom it may be donated to. This is an evidence that Islamic banking is free from any financial exploitation hence create wealth and the alleviation of poverty. Herein, the Divinely inspired Islamic banking system could alleviate the global financial crisis which we face today. Both the capitalist and the socialist economic system, has dismally failed in achieving this social justice, for which the Islamic economic system is tailored.

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