

Work, therefore, is regarded not only as a right, but also as a duty and an obligation. Hence, based on its notion of individual rights and responsibilities, Islam extends to the individual the right to choose the type of work they desire, but along with this freedom comes the obligation to consider the needs of the society as well as the selection of the type of work permitted by the *Shari'ah*.

Since all class distinctions are negated by Islam, no line of work permissible by the *Shari'ah* is considered demeaning by Islam, which countenances only diversification on the basis of natural talents, skills and technology—which are considered to be a grace or blessing (*fadl*) from Allah (*swt*) and which all Muslims are urged to acquire—or personal inclinations. Based on its concepts of justice and contracts, Islam makes it an obligation for the worker to perform the tasks which he has contracted to the best of his ability. But since individuals are endowed with different abilities and talents, this productivity will differ. Justice, however, demands that the return for every individual's work must be commensurate with his/her productivity.

While Islam has, in no uncertain terms, decried laziness, idleness, and socially unproductive work, it maintains that those who are physically or mentally unable to work still retain a right to what the society, individually and collectively, produces. This conclusion is based on the principle of invariant claim to ownership, which maintains that all human beings have a right to the resources provided for mankind. Since Allah (*swt*) is also the source of the physical and mental abilities that enable some members of society to possess more than others, the right of ownership to the original resources of those less able remains valid. This follows from the fact that Allah's (*swt*) original right of ownership of resources, which He has created, is not negated when they, along with the creative labor of individuals, are transformed into products, property and wealth.

### **The Accumulation and Utilization of Wealth**

Islam encourages man to utilize, to the fullest extent possible, all the resources that Allah (*swt*) has created and entrusted for his use. The non-utilization of these beneficial resources is tantamount to ingratitude. Wealth is considered an important means by which man can pave the way for the attainment of his ultimate objective. Islam refers to wealth as “good,” an object of delight and pleasure, and a support for the community. Conversely, involuntary poverty is considered to be undesirable and a basis of unbelief. This particular conception of wealth, however, is qualified by the means employed in its earning, possession, and disposal.

Its “earning” is qualified by the emphasis put on the fact that wealth is only a means for the achievement of man's ultimate objective and not an end in itself. It must be earned through “good,” “productive,” and “beneficial” work, as defined in the *Shari'ah*, which also defines the methods of lawfully earning wealth. Not only are lawful methods of earning wealth specified, but the types of economic activity that may lead to unlawfully acquired wealth and are prohibited are also set out. The *Shari'ah* specifies non-permissible

professions, trade and economic activity, which may lead to unlawfully acquired wealth. Even within each profession, the *Shari'ah* specifies proper and improper practices. Just as wealth, rightfully earned and purposefully disposed of, is considered a blessing, wealth acquired or accumulated unlawfully for its own sake is condemned as “corruption” and retrogression to the basest of all negative human qualities—greed.

Islam regards wealth as the lifeblood of the community, which must be constantly in circulation; therefore, its possession excludes the right of hoarding.<sup>10</sup> The implication is that wealth, lawfully earned, must be invested within the community to improve its economic well-being. Investing the wealth is not only measured by the monetary gain associated with it, but also by the benefits that accrue to society, a point that must be borne in mind at all times by the owners of wealth.

The disposal of wealth is also subject to the rules of the *Shari'ah*. First and foremost among these rules is the recognition of the rights of others in this wealth resulting from the principle of invariant claim to ownership. These include levies whose amounts are specified and others whose amounts are left to be determined by the wealth-owner. These levies fall due when wealth exceeds a specific minimum amount (*nisab*). After these obligations are met, the remainder belongs to the owner, but it must be used in accordance with the rules of the *Shari'ah*, which forbids extravagance, opulence, waste, or general abuse of wealth. It cannot be used to harm others or to acquire political power or to corrupt the polity.

While Islam treats wealth, lawfully acquired, possessed, and disposed of, to be sacred and subject to the protection of the *Shari'ah*, it regards the wealth-owner as a trustee who holds his wealth as a trust on behalf of Allah (*swt*) and the community. Hence, his inability to use his wealth properly provides the basis for the forfeiture of his right to that wealth. Extravagance, waste, and general abuse of wealth is the basis upon which the community can consider him a *safih*, a person of weak understanding, and one in possession of “weak intellect” and a person who, along with his own financial and a moral loss, is damaging the interests of the community. There is a principle, *hajr*, according to which such a person's wealth is made the ward of the community, or of its legitimate representatives, who may limit his right to the use to only a part of his property to meet his basic needs.

### **The Distribution and Redistribution of Wealth**

One of the most important economic institutions that operationalizes the objective of achieving social justice is that of the distribution/redistribution rule of the Islamic economic paradigm. As mentioned earlier, a crucial mission of all messengers and prophets is the establishment of social justice. In practical terms, the *Qur'an* makes clear that this means creating a balanced society that avoids extremes of wealth and poverty, a society in which all understand that wealth is a blessing provided by the Creator for the sole

purpose of providing support for the lives of all. The Islamic view holds that it is not possible to have many rich and wealthy people who continue to focus all their efforts on accumulating wealth without simultaneously creating a mass of economically deprived and destitute. The rich consume opulently while the poor suffer from deprivation because their rights in the wealth of the rich and powerful are not redeemed.

To avoid this, Islam prohibits the accumulation of wealth, and imposes limits on consumption through its rules prohibiting waste (*itlaf*), overspending, and ostentatious and opulent spending (*israf*). It then ordains that the net surplus, after allowing for the moderate spending necessary to maintain a modest living standard, must be returned to members of the community who, for a variety of reasons, are unable to work and hence whose resources that could have been used to produce income and wealth have been utilized by the more able. The *Qur'an* considers the more able as trustee-agents in using these resources on behalf of the less able. In this view, property is not a means of exclusion but inclusion, in which the rights of those less able are redeemed in the income and wealth of the more able. The result would be a balanced economy without extremes of wealth and poverty. The operational mechanism by which the right of the less able is redeemed is the network of mandatory and voluntary payments such as *zakat* (2.5 percent on wealth), *khums* (20 percent of income), and payments referred to as *sadaqat*. Distribution takes place after production and sale, when all factors of production are given what is due to them commensurate with their contribution to production, exchange and sale of goods and services.

Redistribution refers to the post-distribution phase when the charges due to the less able are levied. These expenditures are essentially repatriation and redemption of the rights of others in an individual's income and wealth. Redeeming these rights is a manifestation of belief in the Oneness of the Creator and its corollary, the unity of the creation in general and of mankind in particular. It is the recognition and affirmation that Allah (*swt*) has created the resources for all of mankind, who must have unhindered access to them. The expenditures intended for redeeming these rights are referred to in the *Qur'an* as *ĪdaqÉt*, a derivative of the root meaning "truthfulness and sincerity." Their payments indicate the strength of the sincerity of a person's belief (2:26; 2:272). The *Qur'an* insists that these are rights of the poor in the income and wealth of the rich; they are not charity (17:26; 38:30; 70:25; 19:51; 2:177). Therefore, extreme care must be taken with the recipients' dignity, which may make them self-conscious to the point that they are reluctant to reveal their poverty. The *Qur'an* consequently recommends that payment to the poor be done in secret (2:271–73) and without reproach, ill-treatment or annoyance (2:262–65).

### **Individual Obligations, Rights and Self-interest**

In Islam, human freedom is envisaged as a personal surrender to the Divine Will rather than as an innate personal right. Man is ontologically dependent

on Allah (*swt*) and can only receive what is given to him by the Source of his being. Human rights are a consequence of human obligations and not their antecedent. Man is charged with certain obligations toward his Creator, nature, himself, and other humans, all of which are outlined by the *Shari'ah*. When these obligations are fulfilled, certain rights and freedoms, which are also delineated by the *Shari'ah*, are gained. Limitations that are imposed by the *Shari'ah* on the rights and freedom of the individual are in the direction of removing negative possibilities from human life. The obligations, rights, and limitations defined by the *Shari'ah* must be observed if the individual and the system are to have an Islamic identity.

Within the framework of the *Shari'ah*, individuals have natural rights that are guaranteed, among which is the right of individuals to pursue their economic interests. Islam considers natural rights of the individual as the same rights granted to him by Allah (*swt*). Pursuing one's economic interests, within the framework of the *Shari'ah*, is first an obligation and a duty, then a right that no one can abrogate. What is significant, however, is the fact that if an individual's power and ability to pursue economic interests are lacking, the obligation is no longer incumbent upon the person, while their rights are still preserved. The right to economic benefits is never negated as a result of a lack of ability to undertake their duty to pursue their economic interests. The potential right remains even if a person is unable to actualize it. Conversely, if the person is able but does not perform their obligations, their rights are also negated.

In Islam, and contrary to popular opinion, self-interest is not negated. Islam, in fact, considers it a primary factor in its incentive–motivation system; a necessity in any organized society if the individual is to find it utility maximizing to follow behavioral rules prescribed by the system. Provided that self-interest is defined to cover spiritual and temporal (that is, eternal and temporary) interests, there is not one rule in the *Shari'ah* that does not carry with it its own justification for individual self-interest. It is for his own benefit, material and spiritual, in this world and for his ultimate salvation and felicity in the next, that the individual is invited to follow the rules of the *Shari'ah*. This is made clear by the *Qur'an*, in which all injunctions are generally coupled with the assertion that compliance with them by the individual is for his own benefit. Often the incentives and the rewards for compliance and the retribution for non-compliance, both here and in the hereafter, are enumerated. It is in the context of the pursuit of self-interest that individual obligations and rights, as well as the limits and accountabilities to these rights, are specified by the *Shari'ah*.

### **Competition and Cooperation**

In the Islamic conception of mankind's ultimate end, economic life plays a purely instrumental role. Even in this role, economic affairs are meant only to provide the institutions and mechanisms needed for satisfying man's

economic needs, as man's essence as the supreme creature of Allah (*swt*) is allowed to be manifested in this world. Thus, the economic system designed in accordance with the fundamental principles of Islam assures that man can exercise his eminent dignity, freedom, responsibilities and rights in the conduct of economic affairs. The economic system must be so ordered as not to assign to man a purely instrumental role in achieving the goals of the economy or the state. Islam seeks to guide man to direct individual action and responsible participation in economic affairs in a manner that commits him to community solidarity and cooperation, resulting in a dynamic and growing economy. Thus, the individual is made accountable for the moral effects of his social actions, including those in economic affairs, so that his own inner personal-spiritual transformation and growth is bound to the progress of the community.

Hence, Islam utilizes cooperation and competition in structuring the ideal society through harmonization and reconciliation between these two opposites, but also between equally primeval and useful forces at every level of social organization. From this perspective, one can argue that one of the greatest distinguishing characteristics of Islam is its forceful emphasis on the integration of human society as a necessary consequence of the unity of Allah (*swt*). To this end, the personality of the Prophet (pbuh) is inseparable from what the *Qur'an* considers as the optimal approach necessary for the emergence of solidarity in human society. Every dimension of the personality of the Prophet (pbuh), manifested in his various social roles in the community, is directed toward maximum integration and harmony in the society. Moreover, every rule of behavior, including those in the economic area, is designed to aid the process of integration. Conversely, all prohibited practices are those which, one way or another, lead to social disintegration.

The *Qur'an* and the traditions of the Prophet (pbuh) make clear references to the dual nature of competition and cooperation; that is, human beings can cooperate and compete for good or evil. It is this that leads to the integration or disintegration of society. The fundamental sources, however, emphasize that competition and cooperation must be utilized in probity and piety rather than in evil and enmity.<sup>11</sup> Similarly, Muslims are urged to compete with one another in beneficial and righteous deeds. There is no evidence in these sources that would allow suppression of one of these forces in favor of the other when they are used within the *Shari'ah* framework. Rather, all of the regulatory and supervisory authority invested in the legitimate political authority is directed toward a balanced and constructive utilization of these forces. The *Shari'ah* rules regarding the structure of the market and the behavior of market participants are an example of such balance. Although the rules of the *Shari'ah* regarding economic affairs demarcate limits and boundaries of desirable competitive and cooperative behavior necessary for the provision and preservation of the solidarity of society, the individual always remains the identifiable agent through whose action (and on whose behalf) all economic activities take place.

## Governance

In addition to the above, there are other individual and collective behavioral rules and norms that strengthen the governance structure of the state and firms, including transparency, accountability, voice, and representation. Nevertheless, the three basic institutions—property rights, contracts, and trust—give a flavor of the strength of governance in Islam. The rule of Law governs the behavior of state rulers no less stringently than those of individuals. As Anderson and Coulson (1958) observe: “Islam is the direct rule of God. His Law, the *Shari’ah*, is the sole criterion of behavior,” and “the authority of the temporal ruler is both derived and defined by this law.” Under the rule of Law, “the ruler is by no means a free agent in the determination of the public interest,” and the decisions that the ruler makes “must not be arbitrary, but rather the result of conscientious reasoning on the basis of the general principles of the *Shari’ah* as enunciated in the authoritative texts.” These legal experts also assert that, based on their consideration of Islamic legal texts, the command of observing contracts and covenants faithfully “apply to the ruler acting in a public capacity” just as severely as to individuals. “Indeed, when considerations of expediency and public interests are taken into account, they apply even with greater force to the actions of the ruler.” Therefore, a breach of faith on the part of a ruler is more heinous in its nature and serious in its consequence than that of individuals. Importantly, they observe:

*. . . just as the ruler has no special prerogative or exemptions as regards the substantive law, so he has none regarding the application of the law through the courts. Ideally, the jurisdiction of the Qādi (the judge), the only person qualified to apply the Shari’ah, is comprehensive and exclusive. The principle that no one can be judge in his own cause is firmly established in the legal texts, and when personally involved, the ruler should submit to the jurisdiction of the ordinary Qādi’s courts. . . . [T]he ruler that breaks faith cannot shelter behind any claim of sovereignty from the dictates of the law which brooks no such plea.*

The same principles of governance under which a ruler or a state should function apply also to firms. Iqbal and Mirakhor (2005) argue that within the Islamic framework a firm can be viewed as a “nexus of contracts” whose objective is to minimize transaction costs and maximize profits and returns to investors subject to constraints that these objectives do not violate the property rights of any party, whether it interacts with the firm directly or indirectly. In pursuit of these goals, the firm honors all implicit or explicit contractual obligations. As can be discerned from the discussions on contracts and trust, it is incumbent on individuals to preserve the sanctity of implicit contractual obligations no less than those of explicit contracts. By the same token, firms have to preserve the sanctity of implicit and explicit

contractual obligations by recognizing and protecting the property rights of stakeholders, community, society, and state. Since the firm's behavior is shaped by that of its managers, it becomes their fiduciary duty to manage the firm as a trust for all stakeholders in ensuring that the behavior of the firm conforms to the rules and norms specified by the Law (Iqbal and Mirakhor 2004).

## **ECONOMIC JUSTICE IN ISLAM**

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A just economy is part of a just, healthy, and moral society, which is the central objective of Islam. What underpins all the rules of behavior prescribed by Islam is its conception of justice, which maintains that all behavior, irrespective of its content and context, must, in its conception and commission, be based on just standards as defined by the *Shari'ah*. Islam considers an economy, in which the behavior of its agents is so conceived, as an enterprising, purposeful, prosperous, and sharing economy in which all members of society receive their just rewards. Such an economy is envisioned as one in which economic disparities that lead to social segmentation and divisiveness are conspicuously absent. Another important rule is the prohibition against taking (that is, receiving) interest. This issue will be covered in detail later.

The components of economic justice in an Islamic society are (i) equality of liberty and opportunity for all members of society with respect to the utilization of natural resources; (ii) justice in exchange, and (iii) distributive justice—all accomplished within the framework of the *Shari'ah*. In this conception, liberty means that a person is not prevented by others from combining his creative labor with resources which are designated by the *Shari'ah* for the use of the individual members of society. Opportunity, on the other hand, represents a favorable conjunction of circumstances, which gives the individual the chance to try it and success is dependent on the individual's efforts and abilities. This equality of opportunity must be secured deliberately by the collectivity. It not only denotes free and equal access to physical resources, but, generally, also extends to technology, education, and environmental resources. The basis for this equality of access to resources and equality of opportunity to use them is Islam's position that natural resources are provided for all members of the society. Even if the opportunity to use these resources is not available to some, either naturally or due to some other circumstances, their original claims to resources remain intact and are not nullified. They must be remunerated for these claims, at some point in time, by the other members who happen to have "or get" greater opportunity to use them.

The idea is that, by mixing their creative labor with resources, individuals create a claim of equity to the possession of the assets thus produced, by virtue of which they can participate in exchange. To allow exchange to take place on the basis of just standards, Islam places a great deal of emphasis on the market and its moral, just and—based on these two factors—efficient

operation. To assure justice in exchange, the *Shari'ah* has provided a network of ethical and moral rules of behavior, which cover in minute detail the behavior of all participants in the market. It requires that these norms and rules be internalized and adhered to by all participants before they enter the market. A market that operates on the basis of these rules, which are intended to remove all factors inimical to justice in exchange, yields prices for factors and products that are considered "fair" and "just." Unlike the scholastic notion of "just price," which lacks an operational definition, the Islamic concept refers to the price prevailing as a result of the interaction of economic forces operating in a market in which all rules of behavior specified by the *Shari'ah* are observed and adhered to by all participants. It is an *ex post* concept, meaning that a just price has been paid and received.

The rules governing exchange in the market cover *Shari'ah*-compatible sources of supply and demand for factors and products before they enter the market, *Shari'ah*-based behavior on the part of the buyers and sellers, and a price-bargaining process free of factors prohibited by the *Shari'ah*. Hence, market imperfection refers to the existence of any factor considered non-permissible by the *Shari'ah*. The rules regarding supply and demand not only govern the permissibility of products demanded and supplied, but also look beyond these phenomena to their origin. Not all demands for products are considered legitimate, nor are all acts of supplying products permissible. The means by which the purchasing power that gives effect to demand is obtained, and the manner in which the production of commodities for their supply takes place, must have their origins based on just standards. Rules governing the behavior of participants in the market are designed to ensure a just exchange. The freedom of contracts and the obligation to fulfill them; the consent of the parties to a transaction; non-interference with supplies before their entry into the market; full access to the market to all buyers and sellers; honesty in transactions; the provision of full information regarding the quantity, quality and prices of the factors and products to buyers and sellers before the start of negotiation and bargaining; and the provision of full weights and measures are all prescribed. On the other hand, behaviors such as fraud, cheating, monopoly practices, coalitions, and combination of all types among buyers and sellers, underselling products, dumping actions, speculative hoarding, and bidding-up of prices without the intention to purchase are all forbidden. All in all, any form of behavior leading to the creation of instantaneous property rights without a commensurate equity created by work is forbidden. A market in which all these conditions are fulfilled produces fair and just prices for the factors and products. These are just or equitable not on any independent criterion of justice, but because they are the result of bargaining between or among equal, informed, free, and responsible men.

Islam's emphasis on moral and just conduct in the marketplace is remarkable in its vigor. A producer or a businessman whose behavior complies with Islamic rules is said to be like the prophets, martyrs, and the truthful friends of Allah (*swt*). He is ranked with the prophets because he, like the prophets, follows the path of justice; like martyrs because they both fight against



heavy odds in the path of honesty and virtue; and like the truthful because both are steadfast in their resolves. Islam asks participants to go beyond the rules of the *Shari'ah* and extend beneficence to one another as a safeguard against injustice. Beneficence implies helping others in ways not required by justice. It is thus different from justice, which prescribes just limits to selfishness. While justice regulates and limits selfishness, beneficence rises above it. Moreover, participants in the market are not only responsible for their own just behavior, but because of the obligation of “enjoining the good and forbidding the evil” they are also made responsible for the behavior of their fellow participants. Islam maintains that when a man sees another committing an injustice toward a third and fails to attempt to remove that injustice, he becomes a party to that injustice. If the person failing to help is himself a beneficiary of this injustice, then his failure is considered tantamount to supporting it. Although provisions are made for coercive and corrective action by legitimate authorities, the clear preference is for self-management of the market. Any interference in the operations of such a market—through price controls, for example—is considered unjust, a transgression and a sin.

It was in response to the rules of market behavior imposed by the *Shari'ah* that led the Muslims early in their history to structure their markets in the form of bazaars, which looked almost the same all over the Muslim world and possessed characteristics that promoted compliance with the rules. Physically, bazaars were structured to guarantee maximum compliance with these rules. Each physical segment of the market was specialized with respect to specific products and the prices showed little variation from one part of the market to the next. The institution of guilds made self-regulation of each profession and trade possible. Additionally, markets were inspected for compliance by a market supervisor (*muhtasib*) who was appointed by local judges. Unfortunately, the institution of bazaars did not have the opportunity to evolve to meet the requirements of an expanding economy or the growing complexity in economic relations. The bazaars that still exist in many parts of the Muslim world, while maintaining their underdeveloped physical and infrastructural nature—most are centuries old and have not been expanded—lack many of the Islamic characteristics and requirements in their operations.

The last component of Islamic economic justice, distributive justice, is the mechanism by which equal liberty and equity are reconciled without the least possible infringement of either. Insofar as the distribution of resources—the just and equal access to these resources, as well as equal opportunity in their use—is guaranteed, the claim to equity on the basis of reward and effort is just. The moral basis of property is the primacy given to equity and it is derived directly from human efforts and achievements. The bases of private property in Islam are: (i) property which is derived from personal ability and effort, including material property made or obtained from natural resources by combining them with personal skills, ability, and technology, income from self-made capital, assets acquired in exchange for the product of the owner's labor; (ii) property acquired by transfers from the

producer; and (iii) property acquired through inheritance from the producer. Rules regarding distributive justice operate through the second and third of these bases.

Assuming equal liberty and opportunity, whenever work has to be performed for the production of wealth, the output of different people may vary greatly both in quality and quantity. Equity then demands that, commensurate with their productivity, different people receive different rewards. Hence, starting from the equality of liberty and opportunity of access to resources, equity may lead to inequality. Moreover, the allocation of resources arising from the operation of the market will reflect the initial distribution of wealth as well as the structure of the market. Assuming that both the operation and the structure of the market are just, there is no logical reason to assume that the market outcome, by and of itself, will lead to equal wealth distribution. Consequently, the result may be (and often is) that inequalities, equitably created, will have immediate and longer-term implications. It is here that the distributive mechanisms of Islamic economic justice attempt to modify inequalities equitably created.

As we saw earlier, Islam recognizes claims based on equality of liberty and opportunity, which are reflected in the degree of access to resources, the degree and extent of the ability of persons to actualize their potential liberty and opportunity, and the right of prior ownership. The right that the less able have in the wealth of those who have greater ability and opportunity to produce greater wealth is redeemed through the various levies (*zakat*, *khums*, *sadaqa*, *nafaqa*, and so on), the payment of which is not beneficence but a contractual obligation that must be met. Islam also encourages beneficence over and above these obligatory dues, but these levies are in the nature of returning to others what rightfully belongs to them. Shirking from this obligation causes a misdistribution of wealth, which Islam considers as the major source of poverty.

Islam asserts unambiguously that poverty is neither caused by scarcity or paucity of natural resources, nor by a lack of proper synchronization between the modes of production and distribution. Rather, it is a result of waste, opulence, extravagance, and non-payment of what rightfully belongs to less able segments of the society. This position is illustrated by the Prophetic saying that: "Nothing makes a poor man starve except that with which a rich person avails a luxury." This is why waste, abuse of wealth, extravagance, and excessive consumption are condemned as unjust, particularly when they occur in conjunction with poverty that they can help to alleviate. In the morality of property, Islam unequivocally considers all individuals entitled to a certain standard of life; and it is this entitlement that entails the satisfaction of their claim as a matter of equity and justice.

In Islam, the rules of inheritance modify the distribution of wealth to the next generation based on the principle that the right of the owner to his wealth ceases upon his death. The power of the person to bequeath his wealth as he wishes is recognized, but is basically restricted to a maximum of one-third of his net assets.

The *Qur'an* (4:11–12) clearly specifies the exact manner in which the shares of heirs are to be determined in the inheritance. Among the same category of heirs there is neither preferential treatment nor discrimination, though a woman's share is generally one-half of a man's share because, under the rules of the *Shari'ah*, responsibility for the maintenance of the family rests upon the husband. Even if the wife has a larger income and greater wealth (from her own work or from inheritance), she is not required to share that wealth or income with her husband and is under no legal obligation to make any contribution toward her family. Considering the nature of the (extended) family ties and mutual responsibilities exhorted by Islam, its institution of inheritance breaks up the wealth of each generation and redistributes it to the next in such a way that a large number should receive a modest portion of such wealth, rather than it going to a single heir or a small number of heirs.

### **Role of the State**

Since Islam considers economic relations and behavior as the means of social and spiritual integration, economic attainments are not to be viewed as ends in themselves. All the rules of behavior regarding economic matters are addressed to individuals and their collectivity, which is represented by the state. The state is regarded as being indispensable for the orderly organization of social life, the achievement of legitimate objectives, the creation of material and spiritual prosperity, and the defense and propagation of faith. The state is primarily a vehicle for implementing the *Shari'ah* and derives its legitimacy from its enforcement of the *Shari'ah* rules. It is assumed to be empowered to use, within the limits of the Law, all available means at its disposal to achieve the objectives and duties prescribed for the collectivity, including the synchronization of individual and public interests.

Foremost among the collective duties is that to ensure that justice prevails in all walks of social life. Thus, the establishment of a judiciary or judicial system, with all the apparatus necessary for carrying out the verdicts of the courts, free of any charges and available to all, is regarded as an indispensable duty of the state. Another of its duties is to guarantee equal liberty and opportunity in access to and use of resources identified by the *Shari'ah* for the use of individuals. This covers making the provision of education, skills and technology available to all. When both equal liberty and equal opportunity are provided, then the production of wealth, its possession and exchange become matters of equity. All of the infrastructure necessary for markets to exist and operate has also been traditionally the responsibility of the state. The first market for the Muslim community was built in Medina at the direction of the Prophet (pbuh) who required that trade be allowed to take place in that market freely, without any charges or fees imposed on the participants and appointed supervisors for the market. On this basis, jurists have recognized market supervision, and its control only when necessary, as a duty of the state.

As we have seen, Islam recognizes as inviolable the right of those unable to actualize their potential to have equal liberties and opportunities in the wealth of those more able. Thus Islam, as praxis for the believer, requires a balance between libertarian and egalitarian values. Where payment of the obligatory levies mandated under *Shari'ah* rules is shirked, the state has a responsibility to correct the resulting misdistribution.

The eradication of poverty is undoubtedly one of the most important of all duties made incumbent upon the state, second only to the preservation and propagation of faith, whose very existence is considered to be threatened by poverty. Islam regards poverty primarily as a failure on the part of the more able and wealthy members of society to perform their prescribed duties. Hence, the commitment to distributive justice, which normally constitutes a large portion of governments' budgets in other systems, is placed squarely on the shoulders of the individuals with the financial and economic capability to meet it. Not only does the *Shari'ah* specify who must pay, but it also designates explicit categories of recipients.

To summarize, the role of the state in an Islamic economy relates, firstly, to ensuring that everyone has equal access to natural resources and means of livelihood; secondly, to ensuring that each individual has equal opportunity—including education, skills, and technology—to utilize these resources; thirdly, to ensuring that markets are supervised in such a manner that justice in exchange can be attained; fourthly, to ensuring that transfer takes place from those more able to those less able in accordance with the rules of the *Shari'ah*; and, finally, to ensuring that distributive justice is done to the next generation through the implementation of the laws of inheritance. The state is then empowered to design any specific economic policy that is required in order to guarantee the attainment of these objectives. To meet the necessary expenditures associated with the performance of its duties, the *Shari'ah* has given the control, utilization, and management of a portion of a society's natural resource endowment (mineral resources, for example) to the state. The consensus of opinion among jurists is that the state is also empowered to impose taxes whenever there is a gap between the resources it can command and its expenditures. Borrowing by the state, when it does not involve paying interest, is permitted when and if necessary.

## **SIGNIFICANCE OF BARAKAH**

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An important aspect of the analysis of an economic system relates to the incentive-motivation structure which the system embodies. The purpose in considering this aspect is to determine whether or not an individual within the system will find it utility maximizing to follow the behavior rules prescribed by the system. If the answer is in the affirmative, then the system as a whole will operate according to its rules. If the rules are not incentive-compatible, there will be deviations from those rules.

The incentive-motivation aspects of the Islamic system have their origin in the basis of belief in Islam, which considers adherence to its rules of behavior as primarily serving the best interests of the individual, both in this world and the next, as well as those of the society as a whole. Islam has provided these rules without negating either the drives or the self-interests of the individual. At the same time, its Law has provided methods and procedures whereby the interests of the community can be protected, should the individual feel it utility maximizing to violate the rules and thereby damage the community's interests.

An important factor in the incentive system of Islam is the concept of *barakah*, which serves as the material inducement for the individual to follow the path of proper conduct. This notion refers to an "invisible but material" blessing whose results can be observed by any believer who engages in righteous conduct. It encompasses the whole spectrum of man's conduct, including, most importantly, his economic behavior. The concept maintains that righteous conduct—that is, behavior whose motivation and objective is to please Allah (*swt*)—will have returns with an increasing rate. The more righteous the conduct, the greater is the presence of *barakah*. This concept asserts that expending wealth in this cause (without expecting a return from the receiver directly) will lead to its expansion. Such actions will, in fact, bring manifold returns to the giver. The concept establishes a positive correlation between the system's conduct and prosperity and encourages Muslims to go beyond the minimum requirements of the *Shari'ah*. The converse of the concept also holds true. That is, unrighteous conduct in earning, possessing, or disposing of wealth will rob its holder of its *barakah*. This applies not only to individual behavior, but to the community as a whole and because the results of the operation of *barakah* are observable, it serves as an incentive for compliance with rules.

## **THE MODEL OF MAN**

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The Islamic economic paradigm is a Creator-centered conceptualization of reality. Its view of man distinguishes between the exterior, physical form (*bashar*) and the non-physical, substantive and internal substance full of potentialities (*insan*). The two concepts roughly parallel man and human. In exteriority, they are similar in appearance, but there are significant differences between the two. The most important difference between the two is an active awareness of the supreme Creator and Cherisher Lord of the Worlds which separates a "*bashar*" from an "*insan*." Those of mankind who become aware and conscious of their human state and its potentialities focus on continuous actualization of this potential. The passage from *bashar* (man) to the perfect human state is seen as an upward spiral movement marked by the degrees of compliance with the prescribed rules of behavior.

In the ideology of Islam, man possesses a dual dimension: his body connects him to the material world but he also possesses a cosmic dimension

through his soul, which is in ceaseless journey towards the final meeting with Allah (*swt*).

The sole declared purpose of man is to “serve” Allah (*swt*) and to do so in accordance with His commands. This service (*ibada*) is the implementation of the divine imperative for man and is for his own benefit. The notion of service indicates the act of the removal of barriers (material and otherwise) which exist along the path to that final meeting.

Man’s designated role as Allah’s vicegerent on earth, bestows particular responsibilities which are composed of developing his own potentialities and struggling for the creation of a just and moral social order. Man is provided with material and extra-material means to assist him in discharging his duties. Through his intelligence and will, he can discern and then choose between right and wrong, between just and unjust, between true and false, and between the real and the illusory. Although this power of discernment has been imprinted on his soul, he is provided with guidance in the form of the *Qur’an* and with reminders in the persons of the prophets and others to show him the “right path.” These are there to remind him that there will come a day of reckoning, “the Hour,” when deeds and misdeeds will be judged. Through these means, he is constantly reminded of the transitory nature of this world and the permanence of the next, of what he must do to earn happiness in this life and felicity in the next, of his purpose, and of his responsibilities. Finally, all created phenomena in the material world have been subjected to man’s use in order to provide him with the necessary material means to perform his responsibilities. Through his intelligence man is charged with the power to discover the knowledge which is necessary to utilize the natural resources to the fullest possible extent in enabling him, and his kind, to actualize their full potential.

Thus, Allah (*swt*) creates, preserves, guides, and finally judges man vis-à-vis the performance of his responsibilities. Hence, man’s purpose is defined, his responsibilities are designated, necessary means of discharging these responsibilities are provided, guidance and reminders are constantly made available and the promise and criteria of the final judgment, as well as the rewards and retributions commensurate with obedience and transgression, are made known; it is, then, man’s free will and choice which determine which path he, in fact, chooses.

Islam, then, models man as a being whose behavior, including in its economic dimension, is teleological in nature. Whatever he thinks or does is accomplished with his final purpose in mind. His behavior is oriented toward his final destination. Things of this world, including material possessions, represent only the means by which he can come closer to his final goal. In his thought and behavior he is constantly aware of the presence of Allah (*swt*), who is “closer to him than his jugular vein.”<sup>7</sup> This awareness extends not only to the individual’s own affairs, but, particularly, also to his day-to-day dealings with others. This ever-present consciousness (*taqwa*) is a crucial concept in the *Qur’an* and represents an “awe,” a “fear,” or a “heeding,” which a believer feels when fully conscious of Allah’s (*swt*) presence in

his daily life and in his dealings with others. It represents a defense mechanism, an “inner torch” by which man can distinguish between right and wrong, seeming and real, ephemeral and lasting. It is by this mechanism that he can defend himself against the temptations of the lower instincts. The becoming process and the evolutionary process toward perfection take place through the constant strengthening of this inner torch.

## **SOCIETY**

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The central aim of Islam is to establish a just, moral, and viable social order through the agency of man. Hence, the individual and the society are viewed as correlates. The position of vicegerent and its concomitant responsibilities are conferred upon all of mankind. Humanity has a collective responsibility to ensure that every human being has the opportunity to tap their dormant potential and to remove all obstacles from the individual’s path to the ultimate goal. It is this collective view that evokes the matter of the Unity of mankind, which leads to the equality (that is, before the Law) of its members. Islam enunciates the principle that all mankind has been endowed with the same nature. It assumes, affirms, and confirms the equality of the entire human race and obliterates all basis of distinction except goodness, virtue, and service to Allah (*swt*). The principle of the Unity of mankind is derived from the central doctrine of Unity and Oneness of Allah (*swt*) around which every aspect of Islam revolves. This principle leads to the conclusion that Islamic society is an open-ended community that encompasses humanity as a whole.

The Islamic community was brought into existence as a “community of the middle,” “justly balanced,” a “witness” to all nations, whose chief characteristic is the belief in the certainty of the Absolute and His Oneness.<sup>8</sup> The central function of this community is to “command the good and forbid the evil;” and whose members possess the moral consciousness to fully realize their obligations to their fellow men and to society.

Islam regards communities as having rights and responsibilities distinct from those of the aggregation of their individual members and, like individuals, are accountable for their actions. The *Qur’an* asks Muslims to consider the fate of communities and civilizations that went before them and see how they, through the operations of immutable laws that govern the rise and fall of peoples, received what they deserved and take lessons from it.<sup>10</sup>

The Islamic community, as well as each of its members, is charged with the responsibility of preserving, promoting, and propagating Islamic values and laws if it is to flourish and accomplish its missions and objectives. Islam considers the existence of an Islamic community indispensable for the achievement of the Divine purpose and recognizes that all individuals exist in a cultural and sociological environment and owe much of their perception of the world, and many of their reactions to its phenomena, to this environment and other individuals who share it. Much of the significance of this community relates to the need for acquisition, acculturation, and inculcation of the

basic Islamic values, which, *ipso facto*, represent the growth of a Muslim personality. The well-knit way of life in the Islamic community molds individual behavior in its own design. Islamic principles, which deal with the formation, preservation, and continuation of the Islamic community, reflect the dialectic interaction of psycho-physiological requirements of individuals, on the one hand, and the necessary socioeconomic order envisioned by Islam, on the other. This interaction is absolutely crucial to the development of behavior, including its economic dimension, of the individual and the collectivity envisioned by Islam.

Inasmuch as Islam's greatest emphasis is on the development of the individual's active moral consciousness in all his/her social interactions, the existence of political authority in society does not absolve the individual of the performance of duties with which he/she is charged. Adherence to moral principles and the doctrinal antecedence logically predispose a Muslim to an active and assertive political role in society. It is the active moral consciousness of the individual and the duty of "commending the good" and "forbidding of evil" which give the individual Muslim the right and the obligation to participate in the affairs of the community.

## THE POLITY

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Islam considers justice as the foundation of the polity. The Unity of Religion and the Law, which exists in principle, must be carried out in practice. Without an organized political authority the existence of both Religion and the Law may be endangered; without the constraints of the *Shari'ah*, the polity will degenerate into an unjust and tyrannical political order. Only in pursuit of justice can the polity be expected to fulfill the ends for which it was established. The pursuit of justice results in a convergence between the interests of the ruler and the ruled, leads to the improvement of social and economic conditions, and enhances the power of Islam in society. Two factors are necessary for this: the moral consciousness of the individual in not transgressing the limits set on their behavior by the *Shari'ah* and the faithfulness of the political authority to the terms of its contract in ensuring that the rules of the *Shari'ah* are implemented.

## ENDNOTES

1. This concept was originally articulated by As-Sahid As-Sadr (M.B.) in *Iqtisaduna* (1987). Along with the first two principles of property, this provides the justification for the dictum that in the property of the rich there is a right for the poor and serves as the basis for legislation empowering transfer of income and wealth as well as rules against waste and extravagance in consumption.
2. In a direct, clear, and unambiguous verse (6:152), the *Qur'an* commands: ". . . fulfill the Covenant of Allah." In an equally clear verse (5:1), it generalizes this imperative to all contracts: ". . . fulfill all contracts."



3. See 16: 91-92; 17:34.
4. See 23:8.
5. See, for example, 5:1; 2:282; 6:151 153; 9:4; 16:91-4; 17:34-6; 23:8.
6. See, for example, 2: 58 and 283; 12: 52; 23: 1-8; and 42: 107, 125, 143, 162, 178, 193.
7. For example, in a few short, but significant statements (quotations from Payandeh 1984), he declares:
  - “The person who is not trustworthy has no faith, and the person who breaks his promises has no religion.”
  - “Maintaining promises perfectly is a sign of faith.”
  - “There are three (injunctions) that no one is allowed to violate: treating parents kindly regardless of being Muslim or non-believer; keeping a promise whether to a Muslim or to a non-believer; and returning what is entrusted for safekeeping—regardless of whether the person entrusting is a Muslim or a non-believer.”
  - “Return what is placed in your trust for safekeeping to the person who has trusted you and do not betray even the one who has betrayed you.”
  - “Three (behavioral traits), if found in a person, then he is a hypocrite even if he fasts, prays, performs bigger and smaller pilgrimages, and says ‘I am a Muslim:’ when he talks, he lies; when he promises, he breaches; and, when trusted, he betrays.”
8. See 2:282; 4:105, 107-08; 6:152; 8:127 and 75-6.
9. See 9:4.
10. *Qur’an* 9:34.
11. See the *Qur’an* 5:2.

## CHAPTER 3

# ***Riba* vs. Rate of Return**

**A**s set out earlier, the Islamic economic system is a rules-based system founded on the preservation of property rights and the sanctity of contracts. Beginning from the notion of property as a sacred trust, the *Shari'ah* ensures its protection from any exploitation through unjust and unfair dealings. The prohibition of *riba* (interest), the elimination of contractual ambiguity (*gharar*) and other forms of exploitation are some of the implications of these core principles.

The significance of contracts and the related obligations cannot be overstated. In this context, financial transactions are no different from any other set of contracts that are subject to compliance with *Shari'ah* principles. Primarily, a financial transaction is considered valid if it fulfills the basic requirements of a valid legal contract and does not contain certain elements such as *riba* (interest), *gharar* (lack of information disclosure), *qimar* (gambling) and *maysir* (games of chance involving deception). While the prohibition of *riba* is the most critical and gets the most attention, the importance of *gharar* and other elements should not be underestimated. Historically, jurists or *Shari'ah* scholars did not cause unnecessary interference in economic activities and gave various economic agents full freedom to contract, providing that certain basic requirements, such as the prohibition of *riba*, were met.

The prohibition of *riba* is not confined to Islam alone, but has a long history spanning several traditions and civilizations (see Appendix A). The prohibition does not arise from any formal economic theory as such, but stems from a Divine order in the *Qur'an*. However, *riba* was not precisely defined at the time of the revelation, an omission often attributed to the fact that since the concept was not in vogue at the time there was no need to provide a formal definition. Defining the term in modern times in any language other than Arabic adds further complexity. For example, unfortunately, there is no single word in contemporary English that serves as an equivalent and accurate translation of the term.

For our purposes, a simple definition of *riba* could be “the practice of charging financial interest or a premium in excess of the principal amount of a loan.”

## THE CONCEPT OF *RIBA* IN ISLAM

Literally, the Arabic term *riba* refers to excess, addition and surplus, while the associated verb implies “to increase, to multiply, to exceed, to exact more than was due, or to practice usury.”<sup>1</sup>

Early Muslim scholars considered money to be a medium of exchange, a standard of value and a unit of account, but rejected its function as a store of value. Lending on interest was prohibited because this was an act of ingratitude and considered to be unjust, since money was not created to be sought for its own sake, but for other objectives. The *Qur'an* (2: 275) makes a clear distinction between engaging in trade and commerce, and earnings through *riba*: “However, God permits commerce, and prohibits usury (interest).” The concept of *riba* was clear in the minds of early jurists, scholars and practitioners. For a long time, and before the introduction of paper currency, the majority of *Shari'ah* scholars always considered the question of *riba* in the context of an exchange contract (*sarf*)—that is, as a sale or exchange of currency or money—or as a sub-heading under trade. Only a few scholars discussed the subject under the heading of loan (*qard*).

*Riba* was interpreted variously by classical scholars as increase which has no wealth (*mal*) corresponding to it; or as reward for waiting; or that which accrues to the lender on account of a deferred payment from an extension in the actual period of loan. At the time of the prohibition, it was a common practice for people to lend money on the condition that a specific amount would be payable periodically as interest and that the principal amount would remain to be paid. At the expiry of the loan, if for any reason the borrower was unable to meet the obligation, the lender would offer to extend the lending period subject to an increased rate of interest. The concept of *riba* is not confined to money-lending, however, but extends to include the exchange of goods as well. *Shari'ah* recognizes two forms of *riba*, as follows:

- *Riba al-nasiah* deals with *riba* in money-to-money exchanges, where the exchange is delayed or deferred and gives rise to an additional charge, as practiced in today's financial transactions. The prohibition under the *Shari'ah* applies regardless of whether the return is a fixed or variable percentage of the principal, or an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan.
- *Riba al-fadl* is more subtle and deals with hand-to-hand or barter exchange. The prohibition is derived from the sayings of the Prophet (pbuh), who required that commodities be exchanged for cash rather than through barter since there may be differences in the quality of goods, which may give rise to an unjust increase. The concept of *riba al-fadl* is remarkably similar to the prohibition of increase in lending victuals in the

Old Testament (Leviticus 25:37). Whereas the Old Testament prohibits quantitative increases, *riba al-fadl* prohibits qualitative increases as well. Considering that in today's markets exchange takes place through the medium of money, the relevance of *riba al-fadl* has diminished, but the essence of the concept remains applicable to similar situations.

## **DEFINITION OF RIBA**

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Focusing on *riba* in financial transactions, it is now possible to construct a more formal definition of the term. According to the *Shari'ah*, *riba* technically refers to the "premium" that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in the duration of loan. At least four characteristics define the prohibited interest rate: (1) it is positive and fixed *ex ante*; (2) it is tied to the time period and the amount of the loan; (3) its payment is guaranteed regardless of the outcome or the purposes for which the principal was borrowed; and (4) the state apparatus sanctions and enforces its collection.

This definition is generally accepted by all and is clear, straightforward, and unambiguous. However, it is the interpretation and scope of the prohibition and its applicability to practical life which raise several questions for *Shari'ah* scholars as new situations arise. The four most commonly asked questions relate to whether the prohibition is limited to consumer loans only, whether only excessive interest or compounding of interest is prohibited, whether adjustment for inflation or any indexation in any form falls within the definition, and whether the prohibition of interest denies the time value of money.

These questions need further exploration and are discussed below.

### **Commercial vs. Productive Loans**

It has been argued that the prohibition of *riba* in Islam was intended to apply only to consumer loans, since the institution of *riba* was used by moneylenders to exploit poor people in a time of need. The logic of the argument is that there were no organized markets for commercial and production financing and the bulk of the lending by individuals was for personal consumption. Charging *riba* on loans for consumption was deemed unfair, unjust, and exploitative, and was thus, as in other traditions, prohibited. It was felt, though, that borrowing money for productive purposes should not fall into the same category.

However, this weak argument is based on a lack of knowledge of the history of the early Islamic period. There is considerable evidence to show that lending for commercial and business ventures existed and the practice of charging interest on such loans was prevalent at the time of the prohibition. First, the practice of lending on the basis of *riba* for agricultural purposes is

well documented. Considering that the economy during that time was primarily an agricultural economy, it is reasonable to conclude that *riba*-based loans for non-consumption purposes existed and were subject to the prohibition. Second, it is a historical fact that the business community of Mecca was part of a sophisticated network of traders and it is known that some of these traders would borrow on the basis of *riba* to finance their trade expeditions. It was a common practice to raise funds to purchase local products before embarking on a trade journey. In some cases, such journeys were undertaken and financed by *riba*-based loans. The Prophet (pbuh) signed a pact with the people of Taif, who were renowned for their moneylending business, which included the condition that *riba*-based businesses be abolished. After the prohibition, the journeys continued, but were financed through partnerships rather than loans.

**Pre-prohibition Lending Practices** Siddique (1995) records the following examples of practices that were common prior to the prohibition of *riba*:

- A person would sell goods to another on the understanding that the price would be paid within an agreed period. If the price was not paid within that period, an amount was added to the price and the period of repayment was extended.
- A person would lend money to another on the understanding that a fixed additional amount would be paid besides the principal, within a fixed period.
- A rate would be agreed between borrower and lender according to which the principal, along with the additional amount, would be repaid. If a further period for repayment was required, then the rate was increased for the extended period.

There is clear and sufficient evidence that at the time of the prohibition, borrowing and lending was for both commercial and productive purposes and therefore prohibition was intended for all forms of lending.

### **Excessiveness or Compounding Only?**

As mentioned earlier, the literal meaning of the word “usury” has changed over time, from simple interest of any kind and at any level to excessive interest above a certain legal limit. This has become a source of confusion for some researchers, who take the current definition to be its original meaning and therefore come to the conclusion, wrongly, that only the charging of excessive interest is prohibited. Similarly, out-of-context interpretation of the verse in the *Qur’an* (3:130) that says “Do not devour interest doubled and redoubled,” often leads to the misunderstanding that the prohibition is for a compounded rate of interest and does not apply to other forms of simple, fair or legal rates.

In refuting the claims that prohibition was meant for excessive interest only, Muslim scholars argue that:

- The verses concerning the prohibition (2:275–81, 3:130–2, 4:161 and 30:39) do not make any distinction between exorbitant or reasonable rates of interest. The injunction in 2:279 (“... and if you repent then ye have your principal”) is a clear indication that, while the principal lent is protected, there is no such protection offered for interest at any level.
- With the help of a simple mathematical formula, it can be shown that doubling and re-doubling of the principal can take place even at a very low interest rate. For example, based on daily compounding (a common practice in today’s financial markets), a \$1 loan will be doubled in 15 years at the rate 4.6 percent.
- The prohibition of interest is associated with the notion of injustice. Researchers refer to the verse which says “... neither should you commit injustice nor should you be subjected to it” (2:279) to argue that *riba* is categorically linked in its totality with injustice and there is no mention of excessive or exorbitant rate.

### **Adjustment for Inflation or Indexation Allowed?**

While the first two issues are relatively easy to resolve, the question of any adjustment or compensation for “inflation” or “deflation” is less straightforward. The question is often raised as to whether money lent without *riba* should be adjusted for any decrease or increase of value over the period of lending. Indexation of financial obligation refers to an adjustment in value over a period of time to compensate for the change in the value arising from inflationary or deflationary pressures. Indexing wages to inflation is a widely common practice, but indexing investments or financial obligations is also growing fast in the conventional financial markets. In the case of financial assets, inflation-linked securities link the returns to the consumer price index or to the cost-of-living index. The adjustments are often in the form of *ex post* adjustments and the objective is to guarantee a return equal to the real interest rate rather than the nominal interest rate.

Indexation is justifiable in the eyes of the *Shari’ah* for wages, salaries and pensions, social security payments, and so on, but it does not support the indexation of financial assets. While some scholars argue that Islam’s notion of justice is grounds for compensation when lending without *riba*, others argue that the prohibition is absolute, pointing to the verse (2:275) that protects only the principal amount of the loan. They argue that the prohibition covers all transactions that may make any adjustments similar to *riba*, such as the deferred exchange of currency, devaluation or revaluation, and the change in the unit of currency at the time of repayment.

The lending of money is a currency transaction that is treated as being similar to the exchange of a commodity, and thus any compensation for the fall in the value of money is not justifiable.

Secondly, scholars also argue that by virtue of the presence of inflation in the economy, the investor's or lender's purchasing power would be at stake irrespective of whether money is lent as a loan on a non-*riba* basis or is invested in a return-bearing security. In either case, the net loss to the lender is a real interest rate or real return. Even if money was not lent but was kept for consumption purposes, the same loss of purchasing power would occur. Therefore, it seems unreasonable to expect the borrower to bear all the loss which is likely to occur to the lender in any case.

Thirdly, it is argued that even if some form of indexation is allowed, it may not be consonant with the notion of justice and therefore may not serve its intended purpose. While it is recognized that inflation represents a loss of purchasing power and indexation is a compensation for such loss, there are several factors that contribute to inflation and the magnitude of each factor and party cannot be determined. Therefore, it is unjust to ask one party to bear the entire burden, while others are burden-free, particularly if the borrower alone is asked to compensate for a loss which may have been caused by factors beyond the borrower's control—including, perhaps, irresponsible government policy.

In discussing the practice of indexation, some argue that there is no perfect index that can fully capture the loss of value. The constituents of the cost-of-living index may not serve as a good proxy for the loss in purchasing power. Also, the index represents the consumption habits of an average person in an economy and since the cost of living may differ from region to region and from city to city, it would not be possible to measure it accurately. This inaccuracy can lead to an unjustified transfer of wealth from the borrower to the lender or vice versa. Similarly, inflation indices are based on a lag and are therefore not readily available to be used in daily financial transactions. All these factors make indexation less practical and prone to biases, which may open a back door for unjustified charges.

*Shari'ah* scholars and economists say that price stability and fiscal discipline have to be achieved to combat inflation. In this respect, the role of the state in causing inflation should receive serious attention. Some economists argue that it is the responsibility of an Islamic state to take effective steps to check inflation in order to minimize the depreciation in the value of money. Where government policies are the source of inflation, the government should compensate the borrower.

As an alternative to indexation as a means of combating inflation, the loan could perhaps be denominated in gold: the lender could lend a certain quantity of gold to the borrower who is obligated to return the same quantity at the expiry of the loan. Other remedies might include the partnership and profit-and-loss sharing instruments of the Islamic economic system, which provide a built-in compensation for inflation because profit is shared

in an agreed ratio whereas losses are borne in the ratio of the respective capital contributions.

### **The Time Value of Money**

It is a common misconception that by prohibiting interest on loans Islam denies the concept of the time value of money. Islamic scholars have always recognized the time value of money, but maintain that the compensation for such value has its limitations. Recognition of an indirect economic value of time does not necessarily mean acknowledging any right of equivalent material compensation for this value in all cases. According to the *Shari'ah*, compensation for the value of time in sales contracts is acknowledged, but in the case of lending, increase (interest) is prohibited as a means of providing material compensation for time.

The Islamic notion of the opportunity cost of capital and the time value of money can be clearly understood by reviewing the distinction between investment and lending. Time by itself does not give a yield, but can only contribute to the creation of value when an economic activity is undertaken. A sum of money can be invested in a business venture or it can be lent for a given period of time. In the former case, the investor will be compensated for any profit and loss earned during that time and Islam fully recognizes this return on the investment as a result of an economic activity. On the other hand, if money is in the form of a loan, it is an act of charity where surplus funds are effectively being utilized to promote economic development and social well-being.

In response to the contemporary understanding that interest on a loan is a reward for the opportunity cost of the lender, Islamic scholars maintain that interest fixed *ex ante* is certain, is tantamount to indulging in *riba* and is therefore unlawful. The element of uncertainty diminishes with time and the resultant return on investment is realized, rather than the accruing of return due to the passage of time. In short, Islam's stand on the time value of money is simple and clear. Money is a medium of exchange; time facilitates completion of economic activity, and the owner of capital is to be compensated for any return resulting from economic activity. Lending should be a charitable act without any expectation of monetary benefit.

### **RATIONALE FOR THE PROHIBITION OF RIBA**

The fundamental sources (the *Qur'an* and the *sunnah*) do not provide any detailed rationale for the prohibition of *riba* beyond asserting, axiomatically, that charging interest is an act of injustice. Contemporary Muslim scholars, particularly the economists among them, have provided various rationales for this prohibition by alluding to the consequences of the existence of interest in modern societies, or by arguing that modern economic theory has not provided any justification for the existence of even the necessity of interest



rates. Some also argue that human wisdom and comprehension are limited compared to the knowledge of Allah (*swt*) and therefore any exercise to fully understand the rationale of the prohibition may not yield any optimal comprehension.

### ***Riba* and Economic and Social Injustice**

One of the primary and the most frequently articulated rationales for the prohibition is that the existence of *riba* in the economy is a form of social and economic exploitation, which violates the core Islamic teaching of social justice. Therefore, the elimination of interest from the economic system is intended to promote economically just, socially fair, and ethically and morally correct economic behavior.

The logic as to why the *Qur'an* has given such a severe verdict against interest is that Islam is against all forms of exploitation and is for an economic system that aims to secure extensive socio-economic justice. Islam condemns all forms of exploitation, particularly the injustice continued in the form of a lender being guaranteed a positive return without assuming a share of the risk with the borrower, who takes upon himself all sorts of risks in addition to contributing his skills and labor. Considering that the wealth an individual possesses is actually a trust held for Allah (*swt*), like a person's life (also a trust from the Creator) the trust of wealth is sacred as well.<sup>2</sup> Then, if that wealth is taken unjustly, an injustice is done to the sanctity of a human being.

The existence of *riba* is not compatible with Islam's value system, which prohibits any form of "unjustified" enrichment (*akl amwal alnas bi al-batil*). By eliminating *riba*, each party to the contract gets a fair and equitable reward, which ultimately leads to more equitable returns and distribution and therefore to a more just economic system.

### ***Riba* Violates Islam's Principles of Property Rights**

The *Qur'an* clearly and strongly condemns the acquisition of the property of others through wrongful means (see 2:188, 4:29, 4:161 and 9:34). Islam recognizes two types of individual claims to property: (a) the property rights that are a result of the combination of an individual's labor and natural resources, and (b) rights or claims to the property that is obtained through exchange, remittances of what Islam recognizes as the rights of those less able to utilize the resources to which they are entitled, outright grants, and inheritance. Money represents the monetized claim of its owner to the property rights created by assets that were obtained or received through either or both of these avenues. Lending money is, in effect, a transfer of these rights from the lender to the borrower and all that can be claimed in return is its equivalent and no more. Interest on money loaned represents an unjustifiable and instantaneous property rights claim. It is unjustifiable because

interest is a property right that falls outside the legitimate framework of individual property rights recognized by Islam. Such a claim is instantaneous because a right to the borrower's property is created for the lender as soon as the contract for lending is concluded, regardless of the outcome of the enterprise for which the money is used.

Money lent on interest is used either productively, in the sense that it creates additional wealth, or unproductively, in the sense that it does not lead to incremental wealth produced by the borrower. In the former case—when the funds are used in combination with the labor of the entrepreneur to produce additional wealth—the money lent cannot have any property rights claim to the incremental wealth because the lender, when lending money, does not bargain for a proportion of the additional wealth but for a fixed return, irrespective of the outcome of the enterprise. He, in effect, transfers the right to his property to the borrower. In the latter case, since no additional wealth, property or assets are created by the borrower, the money lent—even if legitimately acquired—cannot be used to claim any additional property rights since none is created.

## **PROMOTING PROFIT AND RISK SHARING**

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When the Arabs argued that “trade is but like *riba*” (2:275), they were decisively informed that “Allah has permitted trade and forbidden *riba*.” The legal differences between trade and *riba* as set out in the *Qur'an* have been detailed over the centuries by capable Muslim jurists. However, the fact remains that the sophisticated Arab traders of Mecca did not at first see any discernible difference between the Islamic model and the one based on *riba*. The sharing of the enterprise's risks and uncertainties is an extremely important characteristic of Islamic financial contracts. The *Shari'ah* condemns even a guarantee by the working partner to restore the invested funds intact, not only because it removes the element of uncertainty needed to legitimize the agreed distribution of expected profits, but also because the lender will not be remunerated to the extent of the productivity of his financial capital in the resulting profit.

In Islam, the financial instruments for trade and production purposes are based on risk/profit sharing as a return for the entrepreneurial effort and on financial capital. The lender who advances money for trade and production can contract to receive a share of the profit. In doing so, he becomes part-owner of the capital of the enterprise and shares in its risk. As a shareholder in the enterprise, he becomes liable for its debts to the extent of his investment, and receives a return (a dividend) only when a profit is earned. A creditor, on the other hand, as a debenture holder, lends money without the risk of owning and operating capital goods and claims interest regardless of the profit or loss position of the enterprise. The creditor runs a risk, but it is the risk of the solvency of the borrower, not of the success or failure of the enterprise.

## **LACK OF THEORY OF INTEREST**

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Islamic scholars advocating the elimination of interest from the economy highlight the fact that there is no satisfactory theory of interest in the conventional economic theory. This criticism is especially leveled against having a fixed rate of interest. Muslim writers see the existing theories of interest as attempts to rationalize the existence of an institution that has become deeply entrenched in modern economies and not as attempts to justify, based on modern economic analysis, why the moneylender is entitled to a reward on the money he lends.

Typical justifications for interest in any economy include the arguments that interest is a reward for saving, a marginal productivity of capital, and an inevitable consequence of the difference between the value of capital goods today and their value after some time. With such arguments in mind, the following points can be made:

- To the argument that interest is a reward for saving, Muslim scholars respond that such payments could only be rationalized if savings were used for investment to create additional capital and wealth: the mere act of abstention from consumption should not entitle anybody to a return.
- The response from Muslim scholars to the argument that interest is justified as marginal productivity of capital is that although the marginal productivity of capital may enter as one factor into the determination of the rate of interest, interest, per se, has no necessary relation with the productivity of capital. Interest, they argue, is paid on money, not on capital, and has to be paid irrespective of capital productivity. In distinguishing between interest as a charge for the use of money and a yield from the investment of capital, they argue that it is an error of modern theory to treat interest as the price of, or return on, capital. Money, they argue, is not capital, it is only “potential capital,” which requires the service of the entrepreneur to transform the potentiality into actuality; the lender has nothing to do with the conversion of money into capital or with using it productively.
- To the argument that interest arises as the time value of money, Muslim scholars respond that this only explains its inevitability and not its “rightness.” Even if the basis for time preference is the difference between the value of commodities this year and the next, it seems more reasonable to allow next year’s economic conditions to determine the extent of the reward.

It is argued that when a person lends funds, the funds are used to create either a debt or an asset (that is, through investment). In the first case, Islam considers that there is no justifiable reason why the lender should receive a return simply through the act of lending per se. Nor is there a justification, either from the point of view of the smooth functioning of the

economy, or that of any tenable scheme of social justice, for the state to attempt to enforce an unconditional promise of interest payment regardless of the use of borrowed money. If, on the other hand, the money is used to create additional capital wealth, the question is raised as to why the lender should be entitled to only a small fraction (represented by the interest rate) of the exchange value of the utility created from the use made of the funds; the lender should be remunerated to the extent of the involvement of his financial capital in creating the incremental wealth.

### **Sub-optimality of Debt-based Investments**

Some researchers have attempted to explain the prohibition of interest and debt by comparing risk for a given investment financed exclusively by equity with risk for the same investment if it is financed by a mix of debt and equity. Iqbal (2010) notes that risk aversion can be seen as rational human behavior in both conventional and Islamic economics. In conventional economics, this is evident from the extensive use of the Expected Utility Hypothesis (EUH) in decision-making under uncertainty and of Modern Portfolio Theory (MPT) in the selection of financial instruments. Both EUH and MPT are exclusively based on a risk-averse attitude. In Islamic economics, strong condemnation of *mysir* (games of chance, including gambling) and *gharar* (excessive uncertainty about the price, quantity or quality of a commodity or service) lends support to the conclusion that risk aversion is acknowledged as rational human behavior.

Therefore, the author sets the null hypothesis as the variance of a given investment is less if it is financed exclusively on a PLS-basis than that if it is financed by a mix of debt and equity. An investment's future profit or loss outcomes are probabilistic and, therefore, its expected cashflows remain the same whether it is financed exclusively by equity or by a mix of debt and equity as stated in the Miller-Modigliani (MM) theorem of irrelevance of capital structure. However, its variance comes out greater if it is financed by any mix of debt and equity rather than by equity exclusively. Furthermore, its variance increases by a greater margin corresponding to every similar increase in the debt–equity ratio.

The hypothesis is proved mathematically assuming a fixed interest rate, irrespective of its magnitude, in the case of debt financing. The mathematical exercise also shows that similar increases in the debt–equity ratio add to the investment risk posed to a shareholder proportionately more than they add to his/her expected return. Moreover, successive increases in debt financing multiply the bankruptcy risk of underlying investment without affecting its overall return. This means that debt financing minimizes risk for individual lenders, and adds a bankruptcy risk on top of uncontrollable natural risk for underlying investments, leaving its expected return unchanged. The Iqbal (2010) study shows that the risk for a given investment is smaller if it is financed exclusively by equity rather than by a mix of debt and equity. This means that, where interest is permitted, a 1 percent

increase in the debt–equity ratio in the financing of a given investment increases its risk at an increasing rate without increasing its overall expected return. This is probably the consequence of the fact that financing an investment exclusively by means of debt is not observed even in the conventional system where leverage is encouraged.<sup>3</sup>

An important implication of this study is that if prohibition of interest is taken as a restriction on personal liberty without keeping in view the negative macroeconomic externality that it generates in the form of increasing risk to the underlying investment, then it seems dogmatic and coercive. However, if the negative externality of debt financing and its exploding nature is fully understood, prohibiting interest makes more economic sense than permitting it.

### **The Act of Lending is an Act of Charity**

Many Muslim scholars point out that Islam’s prohibition of *riba* has two dimensions: to promote more equitable risk-sharing contracts for business and commercial purposes; and to consider lending as a benevolent act with a view to helping someone in need. If someone needs capital for commercial purposes, then capital should be given on a risk-sharing basis and if someone needs funds to overcome some short-term need, then such need should not be exploited and the borrower should not be put under an undue burden. The benevolence and philanthropic elements of the prohibition of *riba* are supported by the *Qur’an* and the traditions of the Prophet (pbuh).

The *Shari’ah* considers a loan to be a gratuitous contract, encourages Muslims to offer charitable loans (*qard-ul-hassan*), and condemns the accumulation of wealth for its own sake. Granting a loan without *riba* is considered a charitable act worthy of bringing blessings (*barakah*); conversely, lending on the basis of *riba* has far-reaching and less-favorable consequences.<sup>4</sup> Economists argue that acts of charity can play a critical role in economic development.

### **Other Prohibited Elements**

**Gharar** After *riba*, *gharar* is the most important element in financial contracts. In simple terms, *gharar* stems from informational problems and refers to any uncertainty created by the lack of information or control in a contract. It can be thought of as ignorance in regard to an essential element in a transaction, such as the exact sale price, or the ability of the seller to actually deliver what is sold. The existence of *gharar* in a contract makes it null and void.

*Gharar* can be defined as a situation when either party to a contract has information regarding some element of the subject of the contract, which is withheld from the other party, and/or the subject of contract is something over which neither party has control. Classic examples include transactions involving birds in flight or fish not yet caught, an unborn calf in its mother’s

womb, or a runaway animal. All such cases involve the sale of an item that may or may not exist. More modern examples include transactions where the subject is not in the possession of one of the parties and there is uncertainty even about its future possession.

Keeping in mind the notion of fairness in all Islamic commercial transactions, the *Shari'ah* considers any uncertainty as to the quantity, quality, recoverability, or existence of the subject matter of a contract as pointing to the element of *gharar*. However, it leaves it to the jurists to determine the extent of *gharar* in a transaction and, depending on the circumstances, it may or may not invalidate the contract. By prohibiting *gharar*, the *Shari'ah* prohibited many pre-Islamic contracts of exchange on the grounds that they were either subject to excessive uncertainty or were not known to one or both parties to the contract, causing unnecessary disputes and injustice. In many cases, *gharar* can be eliminated from contracts by carefully stating the object of the sale and the price in order to remove unnecessary ambiguities. A well-documented contract will eliminate *gharar* as well.

Viewed as excessive uncertainty, *gharar* can be associated with the element of risk. Some argue that prohibiting *gharar* is one way of managing risks in Islam, as a business transaction based on profit-and-loss sharing will encourage parties to conduct due diligence before committing to the contract. Prohibition would force parties to avoid contracts with a high degree of informational asymmetry and with extreme payoffs, and would make them more responsible and accountable. However, treating *gharar* as risk has its consequences. In prohibiting *gharar*, the *Shari'ah* is also prohibiting the trading of it, thus also prohibiting of the use of derivative instruments designed to transfer risk from one party to another in today's financial markets.

The prohibition of *gharar* by implication includes the prohibition of pure speculation and gambling activities, which involve asymmetric information, excessive uncertainty, risk and lack of control. Although some of the earlier researchers raised concerns about the permissibility of trading in the stock markets on the ground that it amounted to speculation, the stock market is based on some fundamental analysis of economic variables and is subject to a reasonable level of uncertainty rather than pure speculation. The prohibition of *gharar* has also raised concerns in the area of insurance. Some argue that writing an insurance contract on the life of a person falls within the domain of *gharar* and thus invalidates the contract. The issue is still under review and has yet to be fully resolved.

## APPENDIX **A**

# **Usury, *Riba* and Interest: A Historical Perspective**

**A** historical review of the term “usury” brings to light and explains a consistent pattern of prohibition of interest. Usury was defined originally as “charging a fee for the use of money,” irrespective of the level of interest charged. After moderate-interest loans became an accepted part of the business world in the Middle and early-Modern Ages, the word “usury” came to refer to the charging of unreasonable or above-legal rates of interest. According to the Oxford English Dictionary, the term took on this new meaning somewhere between the sixteenth and seventeenth centuries, a meaning it has retained to this day.

The practice of lending money on interest can be traced back approximately four thousand years. Since its earliest incarnations, the practice has been repeatedly condemned, restricted or prohibited on moral, ethical, religious, and legal grounds by various traditions, institutions, and social reformers. The rationale employed by these wide-ranging critics has included arguments about work ethic, social justice, economic instability, and inter-generational equity. Among the religious traditions, the explicit and implicit prohibition of interest is mentioned in Hinduism, Buddhism, Judaism, Christianity and Islam.

The Greek philosopher Aristotle considered money as a means to facilitate exchange and therefore was of the view that a piece of money could not beget another piece. He rejected the justification for charging interest on this ground, arguing that money is sterile. In the Vedic Hindu texts of Ancient India (2000–1400 BC), there are several references to the “usurer” (*kusidin*) as any lender at interest. Further references to “interest” can also be found in the later Sutra texts (700–100 BC), as well as in the Buddhist Jatakas (600–400 BC). It was during this latter period that the first sentiments of contempt for usury were expressed. According to Jain (1929), Vasishtha, a well-known Hindu law-maker of that time, made a special law which forbade the higher castes of Brahmanas (Hindu priests) and Kshatriyas (warriors) from being usurers or lenders at interest. In the Jatakas, usury is

referred to in a deprecating manner, claiming that “hypocritical ascetics are accused of practicing it.”

## **JUDAISM AND INTEREST**

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In Judaism, the Old Testament clearly disallowed dealing with interest as implied by the Hebrew word “*neshekh*” (literally, “a bite”). Similar to *riba*, *neshekh* referred to any gain, whether from the loan of money or goods or property of any kind. While it was not defined explicitly, it was commonly referred to as the practice of the exaction of interest from the debtor by the creditor. In the books of Exodus (22:25) and Leviticus (25:36 and 37), the term applies to lending to the poor and destitute, while in Deuteronomy (23:19–20), the prohibition is extended to include all money lending, excluding only business dealings with foreigners. In addition to the direct mention of interest, there are several references to derivatives—or indirect interest, known as *avak ribbit*, literally “the dust of interest”—which apply, for example, to non-financial transactions and include certain types of sales, rent agreements and work contracts.

## **CHRISTIANITY AND INTEREST**

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In Biblical times, all payments for the use of money were forbidden. There are several references to prohibition of an increase on the amount lent out. Charging interest was condemned throughout the early history of Christianity. In *The Divine Comedy*, Dante places the usurers in the inner ring of the seventh circle of hell, below even suicides.

By the second century AD, usury had become a more relative term which meant charging interest beyond the legal rate, but that did not prevent the Church from continuing to condemn the practice. By the fourth century, the Roman Catholic Church maintained its prohibition on the taking of interest by the clergy and this rule was extended to the laity in the fifth century. In the eighth century, under Charlemagne, the Church declared usury to be a general criminal offence. During Medieval times, lending was considered a gratuitous act and lending on interest was morally wrong. In the early Middle Ages, Popes and Councils continued to oppose all forms of payments for the use of money lent, as money was mainly for the purpose of exchange and its principal use was its consumption. This anti-usury movement continued to gain momentum during the early Middle Ages and, in 1311, Pope Clement V made the ban on usury absolute and declared all secular legislation in its favor null and void.<sup>5</sup>

The end of the thirteenth century saw the decline of the influence of the Orthodox Church and the rise of secular powers and, as a result, despite the Church’s clear prohibition, the practice of charging interest gained some acceptance and tolerance. During the Mercantile Era (1500–1700 AD),



when money began to play a critical role in large-scale commercial transactions and was treated as capital, there were arguments that equated interest with rent on capital, similar to the charging of rent for physical factors of production. With the emergence of the Protestant Reformation and the rise of capitalism, usury was accepted on the grounds that it was sinful only if it hurt one's neighbor, and that was a matter for each individual to determine.

Thus, factors such as changing business practices, the rise of capitalism and pro-usury movements such as the Reformation, led, sometime around 1620, to the practice of usury making a transition from being an offence against public morality, which a Christian government was expected to suppress, to being a matter of private conscience. At the same time, a new generation of Christian moralists redefined usury as excessive interest. For example, the teachings of John Calvin (1509–64) led to the emergence of the Calvinist bankers in Geneva, who were free to develop their financial interests without any feelings of guilt, provided that they observed the Christian teaching on justice to the poor, and that they were totally honest in their dealings. The Catholic Church, however, continued its opposition to usury. In 1740, for example, the Pope vehemently condemned a bond issued at a low rate of 4 percent by the city of Verona. This also indicates that as late as the eighteenth century, the Christian understanding of usury was that it included any form and level of interest and did not refer to excessive interest alone.

### **Prohibition of Usury in the Bible**

In addition to the above-mentioned scriptures in the Judaic tradition, Christians could point to many other texts from the Old Testament to justify the view that usury in all its forms was forbidden. These include:

“He that by usury and unjust gain increaseth his substance, he shall gather it for him that will pity the poor.” (Proverbs 28:8)

“He that putteth not out his money to usury, nor taketh reward against the innocent. He that doeth these things shall never be moved.” (Psalm 15:5)

“Woe is me, my mother, that thou hast borne me a man of strife and a man of contention to the whole earth! I have neither lent on usury, nor men have lent to me on usury [interest]; yet every one of them doth curse me.” (Jeremiah 15:10)

“He that hath not given forth upon usury, neither hath taken any increase, that hath withdrawn his hand from iniquity, hath executed true judgment between man and man . . .” (Ezekiel 18:8)

“In thee have they taken gifts to shed blood; thou hast taken usury [interest] and increase, and thou hast greedily gained of thy neighbors by extortion, and hast forgotten me, saith the Lord God.” (Nehemiah 5:7) and

“Then I consulted with myself, and I rebuked the nobles, and the rulers, and said unto them, Ye exact usury [interest], every one of his brother. And I set a great assembly against them.” (Ezekiel 22:12).

## ISLAM AND INTEREST

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The practice of *riba* was prevalent at the dawn of Islam and when the prohibition was proclaimed, it did not require any further clarification.<sup>6</sup>

As we have seen throughout this book, several verses of the *Qur'an* mention and prohibit *riba*. So explicit and clear was this prohibition that its meaning was rarely challenged. With the introduction of debt securities and commercial banking, which further strengthen the institution of interest, the question has been raised more frequently in modern times. Muslim scholars have always maintained that interest constitutes *riba* and is therefore prohibited. As with Judaism and Christianity, from time to time there have been attempts to justify the practice. Throughout Islamic history, questions regarding interest have been posed to *Shari'ah* scholars and they have predominantly upheld the prohibition. However, in rare cases, there have been exceptions in the form of minority opinions, which often did not last long. Such minority opinions were often given under political influence or were born of a lack of understanding—either of the traditional Law or of the contract in question.

More recently, in 1989 a legal opinion (*fatwa*) issued by Egypt's highest legal scholar, Sheikh al-Azhar Muhammad Sayyid al-Tantawi, gave rise to considerable controversy. His opinion, that banks may fix the rate to be paid to depositors, was supported by the prestigious seminary the Al-Azhar Islamic Research Institute. While the legal opinion may have been valid for a specific situation, it was never intended to lead to a general acceptance of the practice of paying or receiving bank interest. Unfortunately, the banking industry took the opinion as an excuse to claim that interest was permissible. The same legal opinion resurfaced in late 2002, but was immediately refuted by the Council of Islamic Jurisprudence Academy, which categorically declared all forms of bank interest illegal from the *Shari'ah's* point of view. In both cases, the attempts to justify bank interest were met with strong opposition and rejection, with the majority of *Shari'ah* scholars upholding the prohibition.

## INTEREST AND MODERN ECONOMICS

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The majority of modern economists accept the institution of interest as an essential ingredient of the modern economic system. However, from time to time, the notion of charging interest on money is challenged. Silvio Gesell, a successful merchant during the early years of the twentieth century, condemned interest on the basis that his sales were more often related to the price of money (that is, interest) than to consumers' needs or the quality of his products. His proposal of making money a public service subject to a use fee was not welcomed by the banking community and therefore did not gain any popularity. More recently, the German economist Margrit Kennedy has

criticized the institution of interest and has advocated interest- and inflation-free money. Overall, however, critics of interest are rare exceptions among modern economists.

The challenge has come mainly from Islamic scholars. Sheikh Mahmud Ahmad, for example, searched through several theories of interest, developed since the time of Adam Smith, to show that there has been no satisfactory explanation of the existence of a fixed and predetermined rate of return on financial assets. His analysis of the writings of economists such as Keynes, Bohm Bowerk, Cassels, and Samuelson led him to argue that an objective assessment of these writings would lead to the belief that all of these writers held a reasonably strong conviction that the existence of a fixed and predetermined rate of interest was an impediment to the process of economic growth and development.

By the mid-1980s, economic and financial theory had demonstrated that there were disadvantages in the fixed payoff contracts that dominated interest-based banking. It was shown that such contracts create inefficient defaults on financial obligations or non-performing assets. In the presence of asymmetric information, debt contracts also suffer from the effects of adverse selection and moral hazard. Fixed-fee contracts create a fundamental conflict between the interests of the borrowers and the lenders.

As a consequence, socially desirable sectors with low profitability will not get finance; moreover, new entrepreneurs with good projects may not be able to obtain finance in the absence of the security required.

## ENDNOTES

1. Lane's Lexicon defines it this way: "To increase, to augment, swellings, forbidden 'addition', to make more than what is given, the practicing or taking of usury or the like, an excess or an addition, or an addition over and above the principal sum that is lent or expended."
2. According to one of the sayings of the Prophet Mohammad (pbuh), "a person's wealth is as sacred as a person's blood."
3. Excessive leverage is observed in financial institutions and hedge funds but it has been criticized in the wake of the financial crisis of 2007–08. Therefore, ignoring all debt financing is a reasonable assumption.
4. See, for example, the *Qur'an* 30:39, 57:11 and 64:17. The Prophet (pbuh) is also reported as saying that "debauchery and *riba* lead a nation to ruin."
5. Birnie (1952).
6. A minor incident in 605 AD, just a few years before the revelation of Islam, is worth mentioning. The sacred House of God, Kabbah, was damaged by fire and public contributions were called for to repair the damage. However, it was emphasized that only pure, clean, and honestly earned money could be used for this purpose and consequently prostitutes and usurious moneylenders were specifically debarred from contributing. This incident is an indication that even the pagans of Arabia did not consider money earned through lending to be from a clean and ethical source.

## CHAPTER 4

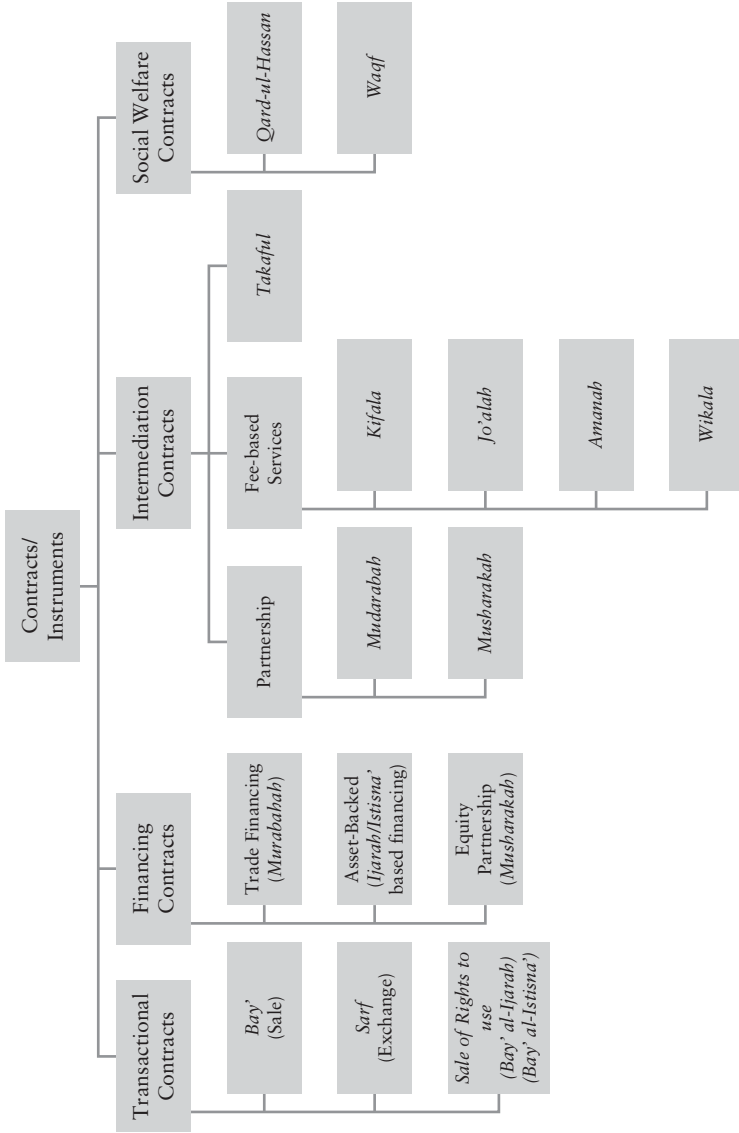
# Financial Instruments

The economic activities in any economic system can be viewed as contracts between economic agents. A financial instrument is also a contract, whose terms and conditions define the risk-and-return profile of the instrument. The whole fabric of Divine Law in Islam is contractual in its conception, content and application. Islam forcefully places all economic relations on the firm footing of “*contractus*”—as discussed in Chapter 2. The preservation of property rights and the commitment to obligations and responsibilities associated with a contract are vital in determining the standards of behavior expected of the economic agents and, ultimately, the nature of the economic system in Islam.

In Islam, a contract is deemed legal and lawful by the *Shari’ah* if the terms of the contract are free of any prohibition. In other words, if a contract does not have or involve any of the prohibited elements, such as *riba* or *gharar*, and does not violate any other rule or law it is considered valid. For example, although a contract to invest in a company producing alcohol may be free of *riba* and *gharar*, it would still be invalid in the eyes of the *Shari’ah*, since it deals with the production of alcohol, which is prohibited in Islam. Several commercial contracts have their roots in the pre-Islamic period but have been further developed and widely practiced after their compatibility with the principles of *Shari’ah* was ascertained and confirmed.

The Islamic economic system has a set of core contracts, which serve as building blocks for designing more sophisticated and complex financial instruments.<sup>1</sup> There is no established classification of contracts in the Islamic legal system as such, but from a business and commercial point of view, certain contracts can be grouped together according to their function and purpose in the economic and financial system. Contracts dealing with commercial and business transactions can be classified into four broad categories as shown in Figure 4.1.

This demarcation and classification based on the function and purpose of contracts give us a framework to understand the nature of credit creation, types of financing instruments, intermediation and the different roles each group plays in the economic system. In other words, theoretically, Islamic commercial law would be able to satisfy the needs of economic agents



**FIGURE 4.1** Contracts/Instruments

through various phases of economic activity, right from the purchase or sale of goods, to arrangements for collateral and guarantees, to arrangements for credit or finance and finally to the creation of opportunities for investment.

**Transactional contracts** deal with the real-sector economic transactions that facilitate the exchange, sale and trade of goods and services. The core transactional contracts are based on trade- or exchange-based activities. Exchange could be on the spot or on a deferred basis and could be of goods for goods, or of goods for price, or goods for promise to pay. These contracts create assets, which further become the basis of financing and investment opportunities; thus they form the very core of an extended economic and financial system.

**Financing contracts** offer ways to create and extend credit, facilitate financing of transactional contracts, and provide channels for capital formation and resource mobilization between investors and entrepreneurs. The distinguishing feature of such financing contracts is the absence of a debt contract. Financing contracts are meant either for the financing of transactional contracts in the form of trade finance or asset-backed securities, or for providing capital through equity partnerships, which can take several forms, such as partnership, co-ownership, or diminishing partnership.

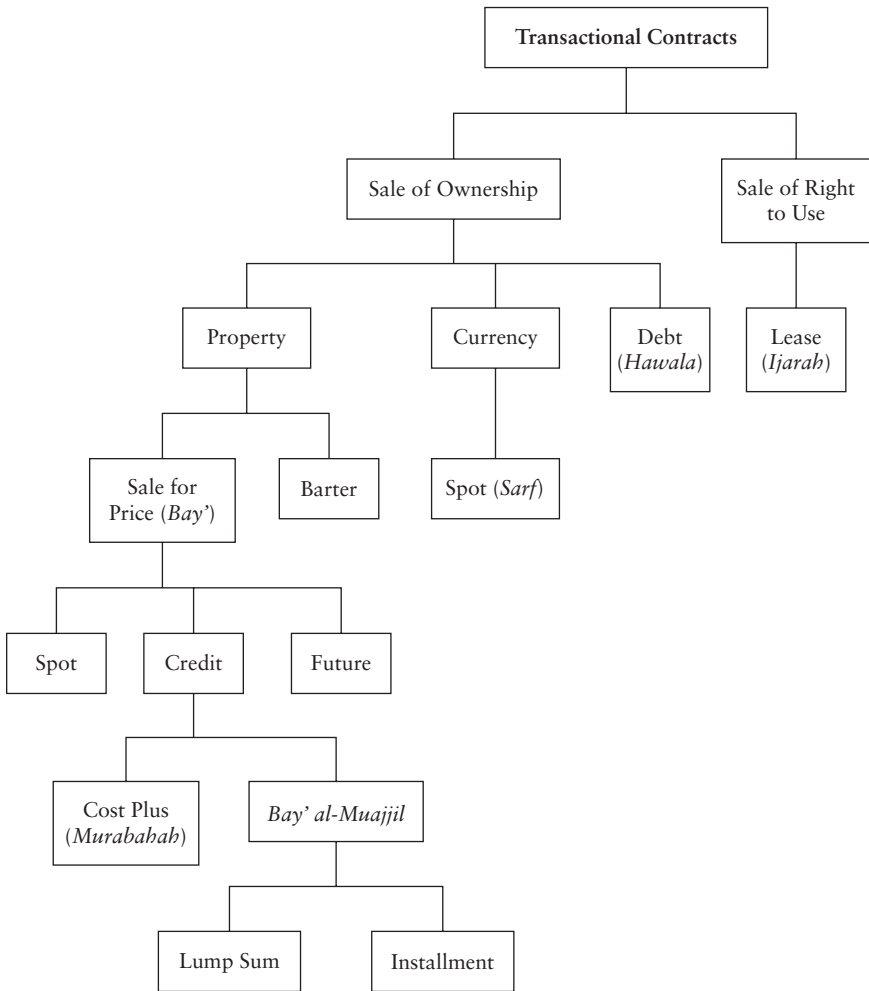
The role of **intermediation contracts** is to facilitate an efficient and transparent execution of transactional and financial contracts. Intermediation contracts provide the economic agents with a set of tools to perform financial intermediation as well as to offer fee-based services for economic activities. These contracts include *mudarabah* (a trustee finance contract), *musharakah* (equity partnership), *kifala* (guarantee), *amanah* (trust), *takaful* (insurance), *wakalah* (agency) and *jo'alah* (fee-based service). In a *mudarabah* contract, an economic agent with capital (*rabbal-mal*) can form a partnership with another agent with skills (*mudarib*), with an agreement to share the profits. Although losses are borne by the capital owner only, the *mudarib* may be liable for a loss resulting from any misconduct or negligence on his part. Intermediation contracts are discussed in detail in the next chapter on financial intermediation.

Finally, **social-welfare contracts** are contracts between individuals and the society to promote the well-being and welfare of the less privileged. Although facilitation of such contracts is beyond the scope of intermediation, an intermediary can certainly offer community services by institutionalizing social-welfare contracts.

## **TRANSACTIONAL CONTRACTS**

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Islam lays great emphasis on promoting trade and gives preference to trading over other forms of business. Trade incorporates not only the trading of physical assets but also of the rights to use those assets. The basic contracts are therefore the contracts of exchange, sale of an asset or sale of rights to utilize an asset. Whereas contracts of exchange and sale result in the transfer



**FIGURE 4.2** Transactional contracts

of ownership, contracts for the utilization of assets transfer only the right to use a property from one party to another. These two types of contracts, from which all others derive, lay the foundation of the principal commercial activities in the economy. Figure 4.2 shows the hierarchy of transactional contracts.

### Contracts of Exchange and Sale

A contract of exchange is primarily concerned with trading, as well as selling and buying activities and their derivatives such as cash sales, deferred-payment sales, deferred-delivery sales, sales on order, debt and currency,

auction sales, and so on. Contracts of exchange include a variety of contracts, which differ from one another in their specific legal requirements, rights, obligations and liabilities, but have a similar result; namely, the transfer of ownership from one party to another. There are specific rules for the exchange of specific types of assets; for example, exchanges of currency and debt can only take place on the spot and any deferment of exchange or payment is not allowed.

There is no concrete way to classify the contract of sale, but it can be viewed from different angles, depending on the underlying asset and/or the modes of payment and delivery. When sale contracts are viewed considering the subject of sale or the underlying asset, sale can be of five types:

- (i) *Bay'*—sale of a property or commodity (moveable or immovable) to another person for a price
- (ii) *Sarf*—sale by exchange of money for money on the spot
- (iii) Sale by barter—exchange of goods for goods, in which neither is a money payment
- (iv) *Bay' al-dayn*—sale of debt or liability
- (v) *Bay' al-salam* (sale by immediate payment against future delivery) and *Bay' al-istisnah* (sale on order). The main feature of such sales is that the item for sale is yet to come into existence at the time of the contract.

Similarly, when viewed from the point of view of the mode of payment, sales contracts fall into the following categories:

- (i) Spot cash sale: The purchaser is under an obligation to pay the agreed purchase price at the time of concluding the contract
- (ii) Installment sale: Where payment is deferred and is to be made in installments
- (iii) Lump sum payment payable in the future: This mode of payment is valid if the date of payment is predetermined and is applicable to all types except *bay' al-salam*.
- (iv) *Bay' al-arabun*: Here, a portion of the full sale price is paid in good faith as earnest money. If the buyer decides not to complete the sale, this advance payment is forfeited to the seller.

In some cases, the sales contract can result in a credit sale where the payment is deferred, but there is a cost involved in deferring the payment. Such contracts (*murabahah*) are discussed in more detail later.

- (v) Deferred payment contracts (*bay' al-muajjil*): This contract allow for the payment for a product in installments or in a lump sum. The price of the product is agreed between the buyer and the seller at the time of the sale and cannot include any charges for deferring payments.

***Bay' al-salam (Purchase with Deferred Delivery)*** *Bay' al-salam* contracts are similar to conventional forward contracts in their function, but have different payment arrangements. The buyer pays the seller the full negotiated price of a



specific product which the seller promises to deliver at a specified future date. However, unlike with a conventional forward contract, the full price is payable at the time of the contract. This forward sale is beneficial to both the seller and the buyer. The seller gets cash to invest in the production process and the buyer eliminates the uncertainty in the future price.

*Bay' al-salam* was permitted as a special case by the Prophet (pbuh) because pre-payment of the price allowed farmers to buy seeds and raw materials, and for personal consumption in order to be able to produce the fruits and crops. The prohibition of *riba* meant that farmers and traders could not take usurious loans and, therefore, they were permitted to sell agricultural products in advance. Similarly, the traders of Arabia who were engaged in importing and exporting goods were permitted to sell their goods in advance as a means of financing business.

The permissibility of *bay' al-salam* was an exception to the general rule that prohibits forward sales. Therefore, it was subjected to some strict conditions, such as the following:

- The transaction was limited to products whose quality and quantity could be fully specified at the time the contract was made. If the quality or quantity of a product could not be so specified, it could not be sold through the *bay' al-salam* contract. For example, precious stones would not qualify, since no two pieces were the same, either in quality or in size or weight and their exact specification was not generally possible.
- Full payment of the purchase price was due at the time of the contract. If payment was not made, it could be misused to create a debt for the sake of selling a debt against debt, which is prohibited.
- The exact date and place of delivery had to be specified in the contract.
- It was permissible to take a mortgage and a guarantor on a *bay' al-salam* obligation to guarantee that the seller performed the obligation to deliver the commodity on the due date.
- The commodity intended to be sold had to be in the physical or constructive possession of the seller.

In the modern economy, *bay' al-salam* can be utilized for several purposes, particularly for the financing of agricultural operations, where the farmers can go through a financial intermediary such as an Islamic bank to buy or sell the produce in the forward market. The bank makes a valuable contribution to economic development by providing financing to farmers and a hedge against price volatility to the users of the produce. In the case of commercial and industrial activities, the use of this contract can help finance small–medium enterprises (SMEs) in providing necessary capital to buy inputs and raw material for the production process.

***Ijarah (Lease)*** Technically, an *ijarah* contract is a contract of sale, but it is not the sale of a tangible asset; rather, it is a sale of the *usufruct* (the right to use the object) for a specified period of time. The word “*ijarah*” conveys

the sense of both hire and lease. In general, it refers to the lease of tangible assets such as property and merchandise, but it is also meant to denote the hiring of personal services for a fee. Renting an asset also comes under the contract. In such cases, the asset is leased for a much shorter period than its actual useful life, which also means that the asset can be rented to multiple users over its life.

Compared to the conventional form of financing, which is generally in the form of debt, leasing results in financing against a particular asset. In a sense, it combines financing and collateral, because the ownership of the asset serves as collateral and security against any future loss. The title to the ownership of the asset remains with the lessor who, in the case of default, can repossess the equipment. In addition, the financing is not dependent on the capital base of the lessee but depends on their creditworthiness to service the rental cash-flow payments.

While the function of the *ijarah* resembles that of the conventional lease agreement, there are some differences between the two. With the *ijarah*, the leasing agency must own the leased object for the duration of the lease. Another difference is the absence of compound interest that may be charged under conventional leases in the event of default or delay in the installment payments. Similarities with conventional leasing make this contract attractive to conventional investors and borrowers as well.

### *Features and Conditions*

- **The Lessor's Responsibilities:** The lessor must be the owner of the asset to be leased. It is the responsibility of the lessor/owner to maintain the property leased, so that it continues to generate benefit for the lessee. The lessor is expected to protect the property by arranging for adequate insurance against any loss or damage to the asset. The lessor/owner is responsible for certain costs and liabilities arising from leasing, such as damage to the asset, payment of any insurance premium costs and basic maintenance. While the cost must be borne by the lessor/owner, for the sake of efficiency, the lessor/owner may authorize the lessee to administer it on his/her behalf.
- All terms of the *ijarah* contract should be stipulated in detail. These terms include the asset being leased, the rental amount, the payment schedule and the purpose for which the asset may be used.
- The leased asset should be treated as a trust in the hands of the lessee.
- The contract is intended for the utilization of the asset and not for its consumption. Therefore, the contract specifies that the object leased must not be perishable or consumable.
- In case of any default by the lessee in making rental payment, the lessor is entitled to revoke the contract and claim the contract price for the remaining period.<sup>2</sup> The lessor/owner may claim compensation for any damage caused to the leased assets as a result of negligence on the part of the lessee.

Recently, Muslim jurists have also provided another contract, *ijarah wa "qtina"* or "hire-purchase agreement," which is similar to the conventional lease-purchase agreements. In addition to the regular *ijarah* contract, this includes a promise by the lessor/owner to sell the leased asset to the lessee at the end of the original lease agreement. The price for the residual value of the asset is predetermined. The second contract thus gives the lessee the option to purchase the asset at the conclusion of the *ijarah* contract or simply return it.

The *ijarah* contract has great potential for developing advanced financial instruments to meet the demands of investors and entrepreneurs. One of the main attributes of leasing practiced today is that the rental flows can be either a fixed amount or a floating amount, which makes it suitable for the different needs of investors. Leasing constitutes a large portion of the portfolios of Islamic banks. However, this share could be higher. One of the reasons why Islamic banks do not increase their lease portfolio is that by becoming the lessor/owner of the asset, they take on additional responsibilities for administering the lease, which is not their main business.

An *ijarah*-based model to provide mortgages for housing is already operating in North America. In addition, the *ijarah* contract has been used in the successful launch of Islamic bonds (*sukuk*), which are discussed further in Chapter 8.

***Istisna'* (partnership in manufacturing)** The *istisna'* contract is suitable for facilitating the manufacture or construction of an asset at the request of the buyer. Once the manufacturer undertakes to manufacture the asset or property for the buyer, the transaction of *istisna'* comes into existence. Both parties (namely, the buyer and the manufacturer) agree on the specifications and price of the asset to be manufactured. At the time of delivery, if the asset does not conform to the specifications, the party placing the order has the right to retract the contract.

One of the important features of *istisna'* is the flexibility it allows as to the mode and timing of payment. It is not necessary that the price be paid in advance nor that it be paid at the time of the delivery. The parties can agree on a payment schedule convenient to both and the payment can also be made in installments.

As with the *bay' al-salam*, the *istisna'* contract is one in which an asset is bought or sold before it comes into existence. However, it differs from the *bay' al-salam* in that (i) it requires the underlying asset to be manufactured or constructed; (ii) there is no requirement to pay the full price at the time of the contract; (iii) it can be cancelled before the manufacturer undertakes manufacturing; and (iv) it provides flexibility in the time of delivery.

Like *ijarah*, *istisna'* also has great potential for application in the area of project finance in different sectors and industries. *Istisna'* have been applied successfully in aircraft manufacturing, locomotive and ship-building industries, and the manufacturing of heavy-duty machinery. The *istisna'* contract

is also suitable for use in the construction industry for building infrastructure such as roads, dams, housing, hospitals, and schools.

## FINANCING CONTRACTS

At one end of the risk continuum, the system offers low-risk asset-based securities, while at the other extreme it promotes risky equity financing, including venture capital and private equity. In between, there are other collateralized securities originating from the *ijarah* or *istisna'* contracts attached to real assets which can cater to the needs of investors looking for short- to medium-term maturity.

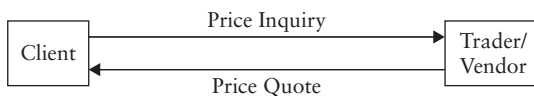
### **Murabahah (cost-plus sales)**

The *murabahah* is one of the most popular contracts of sale used for purchasing commodities and other products on credit. The concept is that a financier purchases a product—a commodity, raw material, etcetera—on behalf of an entrepreneur who does not have the capital to do so. The financier and the entrepreneur agree on a profit margin, often referred to as “mark-up,” which is added to the cost of the product. The payment is delayed for a specified period of time, during which the entrepreneur produces the final product and sells it in the market. To be a valid contract, *Shari'ah* requires that a *murabahah* should be the result of an original sale and should not be used as a means of financing any existing inventory. In addition, the financier must take ownership of the item on sale.

The *murabahah* was originally a sales transaction in which a trader purchased a product required by an end-user and sold it to the end-user at a price that was calculated using an agreed profit margin over the costs incurred by the trader. With the emergence of financial intermediaries such as banks, the trader's role as financier has been superseded.

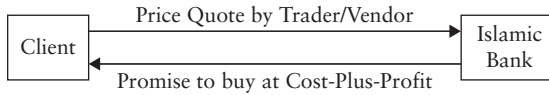
**The mechanics of *murabahah*** A typical *murabahah* transaction as practiced today involves three players—the financier or the Islamic bank, the vendor or the original seller of the product, and the user of the product who requires the bank to purchase and finance on their behalf. The transaction is explained in detail in the following steps:

**Step 1:** The potential purchaser asks the vendor to quote a price for the goods required.

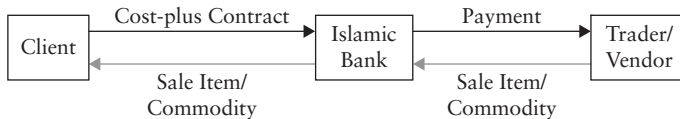


**Step 2:** With this quotation, the purchaser contacts the bank, promising to buy the goods from the bank if the bank buys the same from the vendor

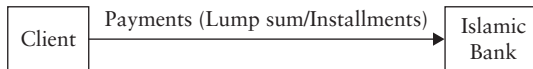
and resells them to the client at the quoted cost plus a profit to be agreed upon mutually. At this stage, the bank would consider entering into a *murabahah* contract, and would set the conditions and guarantees for the acceptance.



**Step 3:** The bank purchases the product from the vendor by making payment. In order to avoid getting involved with accepting the delivery and making arrangements to store the product, often banks appoint the client as their agent to accept the delivery on their (the bank's) behalf.<sup>3</sup> Since the bank is still the owner of the product, a *murabahah* contract is drawn up between the client and the bank indicating the mark-up to be charged and other relevant details. The contract is finalized by agreeing on the mode of payment; that is, a lump sum or through installments. In addition to the contract, the bank also accepts the goods or other assets as collateral against the credit risk or the risk of default in payment by the client.



**Step 4:** The client makes the payment to the bank at the designated time and in the agreed manner. This payment includes the cost of the product to the bank plus a profit margin for the bank.



### Features and Conditions

(i) *Murabahah* must be based on a sale and cannot be used for a purpose other than purchasing a product. For a sale transaction to be valid under the *Shari'ah*, the sale item is really purchased by the financier, who takes ownership and possession of it.

(ii) In the event of default by the end-user, the financier only has recourse to the items financed and no further mark-up or penalty may be applied to the outstanding liability. As opposed to conventional loans, there can be no accrual of interest. It is common practice among Islamic banks to consider the non-payment of two consecutive installments as default, at which stage the bank is entitled to declare that all the other installments are due immediately. In some cases, *Shari'ah* scholars allow the financier to recover additional amounts to offset any loss or damage arising from the default.

(iii) The financier is allowed to ask for security to protect itself against any non-payment in the future. Often an asset other than the item being

financed through the *murabahah* is taken as security, but when no such asset is available, the financier takes the item itself as security. This may require additional claims by the financier on the item financed, such as naming the financier as a beneficiary in the insurance policy.

(iv) The mark-up rate charged by the financier is influenced by the type of product, the type of security and collateral, the creditworthiness of the client, and the length of time for which the financing takes place.

(v) Another distinct feature is that the resulting financial claim resembles conventional debt security characterized by a predetermined payoff. The difference is that Islamic instruments are clearly and closely linked to, and collateralized against, a real asset and are consummated by a transactional contract. As a result, a financial claim is created against a real asset with a short-term maturity and relatively low risk.

Although *murabahah* financing is allowed by the *Shari'ah* and is very popular with Islamic banks, there are some misconceptions about the instrument among those who do not fully understand the contract. The misunderstanding stems from the question of the difference between the mark-up and interest, since *murabahah* results in a financial claim like a zero-coupon bond with a fixed rate of interest. This misunderstanding is further compounded when an outsider observes a close relationship between the mark-up and the prevailing interest rate in the market, such as LIBOR. Researchers have addressed both of these questions.

In distinguishing *murabahah* from a loan, it is pointed out that in the former no money is loaned but a specific asset is purchased for the client to ensure that the financing is linked to an asset. In addition, whereas in lending money as a loan the financier is exposed to credit risk only, in a *murabahah*, the financier is first exposed to the price risk when the product is acquired for the client because the client retains an option to decline to take delivery of the product.<sup>4</sup> Therefore, it is argued that by engaging in buying and selling the product, the bank is exposing itself to risks other than simple credit risk, as well as promoting trading (exchange) of a real asset; hence, a *murabahah* transaction is different from a simple loan.

The confusion in equating *murabahah* with a loan is not a new one. As mentioned earlier, Arab traders posed the same question during the time of the Prophet (pbuh). The legal difference between a *murabahah* contract and an interest-based loan is clear: the former is a sales contract in which the price is increased for deferment of payment; the latter is an increase in the amount of a debt for deferment. The first is permitted, but the second is not.

The practice of using an interest-rate index to determine the mark-up rate has been the source of confusion and the focus of much criticism. Islamic banks often argue that the mark-up rate is the function of an interest-rate index because there is no Islamic benchmark that can provide an indication of the prevailing rate of return in the economy. This necessitates the creation of an index to track the expected cost of capital and the rate of return which can be used to price financial instruments.

**Bai' bithamin ajil (BBA):** In Malaysia and other Southeast Asian countries, a form of *murabahah* in which payment is made in installments sometime after the delivery of goods is referred to as *bai' bithamin ajil*. It is similar to a *murabahah* in that the financier undertakes to buy the asset required for resale to the client at a higher price, as agreed to by the parties involved. However, it differs in that it is used for long-term financing and the seller is not required to disclose the profit margin that is included in the selling price.

**Tawarruq:** Also known as “reverse *mudarabah*,” the *tawarruq* is a mechanism for borrowing cash by undertaking two separate transactions. In a typical *tawarruq* transaction, a person buys a commodity or goods from the seller on credit, on the understanding that the price will be paid, either in installments or in full, in the future. Once the commodity is purchased, it is immediately sold to a third party at a spot price lower than the purchase price. In this way, a loophole is created to borrow money by using two legitimate *Shari'ah* transactions. In financial terms, this mechanism amounts to the creation of a zero-coupon loan, where the cost of borrowing money (interest rate) is at the same rate which the original seller might be charging to defer the payment, excluding any transaction costs.

The practice of *tawarruq* is a recent development in the Middle East market, especially in Saudi Arabia, but it has not received a wide acceptance and there is considerable resistance to the practice. Technically, from the *Shari'ah*'s point of view, the practice is legitimate, but several scholars have condemned its widespread practice on the grounds that it opens the door to borrowing money on the basis of *riba* and without creating any real economic activity, as the same commodity or product might be sold to several borrowers. The practice is disliked by scholars, particularly where the borrower of the money sells the commodity or goods back to the original seller.

### ***Musharakah* (partnership)**

The partnership is a pre-Islamic contract that was widely accepted and promoted by the Prophet (pbuh). The *musharakah*—a hybrid of the *shirakah* (partnership) and the *mudarabah*—is a combination of investment and management.<sup>5</sup> In the absence of debt security, the *Shari'ah* promotes the *musharakah* form of financing and is fairly comprehensive in defining different types of partnerships, in identifying rights and obligations of the partners, and in stipulating the rules governing the sharing of profits and losses.

A *musharakah* or *shirakah* can be defined as a form of partnership where two or more people combine either their capital or labor to share the profits and losses, and where they have similar rights and liabilities. A special case of partnership of capital and labor is known as a *mudarabah*, which is the cornerstone of Islamic financial intermediation. In general, the term *musharakah* is commonly used to refer to partnerships, but there are further sub-classifications of partnerships with respect to the levels of the partners' authority and obligations, and the type of their contributions for example,

management skills or goodwill, and so on. For the sake of our discussion, we will refer to a *musharakah* as a partnership based on capital contribution.

### *Features and Conditions*

- The partnership agreement need not necessarily be formal and written; it can be informal and oral.
- Every partner is an agent of and for the other, as all the partners benefit from the *musharakah* business.
- Every partner enjoys equal rights in all respects, in the absence of any condition to the contrary.
- Every partner has a right to participate actively in the affairs of *musharakah* if they so wish. However, in case of formal legal entities such as limited companies and cooperative societies, partners delegate their rights to participate in the management to professional managers.
- The ratio of each partner's share in the profits is predetermined as a proportion or percentage; no fixed amount can be predetermined.
- There is unanimity among *Shari'ah* scholars that any loss is to be borne by the partners according to their capital contribution. The *Shari'ah* is very clear that if a party has not invested any capital in the partnership, they are not liable for the loss. This implies that any capital investment is subject to the risk of loss of capital, but any investment of labor or time is limited to the loss of the time invested and the loss of capital is not required to be shared by such a partner.
- The *Shari'ah* recognizes the limited liability of shareholders in a *musharakah*-based legal entity, such as a joint stock company or a corporation. Shareholders cannot be held liable for more than their share of capital invested.
- Whereas a partner can withdraw from a partnership after discharging their liabilities as agreed by the partners, a shareholder in a company cannot withdraw from the partnership. They can exit the partnership by selling their share in the market.
- A loss incurred during one period can be carried forward and offset against the profits of the next period, if any. However, until the total loss has been written off, any distribution of "profit" will be considered as an advance to the partners. In order to avoid such a situation, the practice of building reserves from profits against future losses is recommended.

In modern times, Islamic banks have developed what is known as a "consecutive partnership," which considers depositors during a full financial year as partners in the proceeds of that financial year, regardless of the full usage of their funds during this period. Similarly, adjustments are made in the profits for proceeds accrued, but not realized, during a financial period. This was necessary to overcome the accounting problems with the determination of the profit and loss of each depositor based on the deposit



period and also to prevent withdrawals by a depositor from investments funded by the depositor.

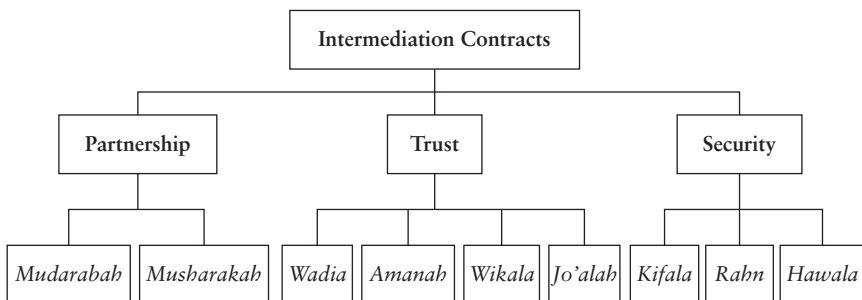
Another form of *musharakah* is being used to provide housing mortgages by forming a contract between the financier and the customer, who own the real estate jointly. This contract is commonly known as a *musharakah mutanaqisah* or “diminishing partnership.” Unlike an *ijarah*-based mortgage, where the ownership of the house remains with the lessor/owner for the entire lease period, ownership in a diminishing partnership is explicitly shared between the customer and the financier. As the name indicates, the ownership of the financier diminishes over time as the customer purchases a share with each monthly payment. The customer’s periodic payments can be divided into two parts; one paying a proportionate rental to the financier based on the financier’s share of the property, and the other as an equity contribution to buy out the financier’s share of the equity. Gradually, over time, the customer is able to buy out the financier’s share and thus acquires complete ownership of the property.

## INTERMEDIATION CONTRACTS

As mentioned earlier, the *Shari’ah* makes provision for a set of contracts, known as “intermediation contracts,” which provide a wide range of typical intermediation services such as asset transformation, payment system, custodial services, and risk management. Intermediation contracts can be further sub-classified into three groups, as shown in Figure 4.3.

### Partnership

The first group of intermediation contracts is the most significant; it deals with intermediation through forming a partnership of capital and entrepreneurial skills. The second group, based on the concept of trust, deals with the placing of assets with intermediaries on the basis of trust for the sake of protection or security. The third group facilitates explicit and implicit



**FIGURE 4.3** Intermediation contracts

guarantees of financial performance between economic agents. These contracts play a critical role in that they provide stability and mitigate risk in the financial system.

Intermediation contracts based on the principles of partnership include both *mudarabah* (a trustee finance contract) and *musharakah* (equity partnership). In a *mudarabah* contract, an economic agent with capital (*rabbal-mal*) can develop a partnership with another agent (*mudarib*) with the skills to form a partnership, with the agreement being to share the profits. Although losses are borne by the capital owner only, the *mudarib* may be liable for any loss arising from misconduct or negligence on his part.

Both *mudarabah* and *musharakah* are cornerstones of financial intermediation for mobilizing resources, and are akin to an agent who develops expertise and knowledge of different markets and acts as an intermediary to screen and monitor investment opportunities for the deployment of funds placed with it. In this respect, *mudarabah* and *musharakah* contracts have existed as instruments of financial intermediation from the early periods of Islam. Both were able to mobilize the entire reservoir of the monetary resources of the medieval Islamic world for financing agriculture, crafts, manufacturing and long-distance trade. These instruments were used not only by Muslims but were also acceptable and practiced by Jews and Christians to the extent that interest-bearing loans and other usurious practices were not in common use.

There is evidence that these two contracts spread rapidly throughout the Middle East and then to the other corners of the globe wherever Muslim traders were active in business and trade. In the Arabian Peninsula, the second caliph is known to have invested the money of orphans with merchants who traded between Medina and Iraq. Similarly, as early as the seventh century AD, tax revenues from Iraq were sent across the desert to Medina (Saudi Arabia) on the basis of *mudarabah*. It has been documented, too, that the trade between Egypt and Tunisia took place on this basis. The practice of *musharakah* is known to have existed in the north–south trade between Egypt and Syria as well as between Egypt and Saudi Arabia, during the eleventh century.

With the encouragement and blessing of early Muslim jurists, partnership-based intermediation contracts were promoted, which led to the evolution of *mudarabah* and *musharakah* contracts as standardized, well-documented and well-established financial instruments. However, around the eleventh and twelfth centuries, further advancements in these contracts slowed, with the result that further innovation of financial instruments became limited. However, the concept was expanded further in Europe, where the business community constantly expanded its partnerships and invented larger and larger enterprises. The increasing size of European partnerships meant that the savings of the small investors were effectively channeled into large investment projects. The concept of the joint-stock company or the modern-day corporation grew out of the concept of partnership, but on a larger scale.