RIBA AND ISLAMIC BANKING AND FINANCE

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1.0. INTRODUCTION

The history of *riba* was dated to about 4000-3000 years B.C. as evidenced from Bottomry Contract that was prevalent amongst the Babylonians. They used to lend money to the merchants in consideration for a certain percentage of usury. It was this contract that was later known as the Bottomry Contract. The origin of *riba* in the medieval period could be linked to the origin of banking itself. The origin of both was mainly influenced by the role of goldsmiths. Goldsmiths allowed the public to keep its gold and silver coins in their safes, possibly charging a fee for the service provided. Naturally, the goldsmiths issued receipts acknowledging the exact amount of gold and silver coins that were handed for them for safekeeping. These receipts enabled the holders to claim and redeem their money at any time. However, as people gained confidence in the goldsmiths, some of them began to use those receipts as a medium of payment without redeeming their money each time they needed to make payment. Gradually, these receipts came to be accepted as money and the gold and silver coins became reserves for the receipt.

Goldsmiths, after some time, realised that most people had been leaving idle their deposits in the banks, and instead used the acknowledgement receipts as payment to others. As such, not many gold and silver coins were in fact taken out physically. Goldsmiths, later bankers, after observing the above pattern for a long time, began to issue additional receipts and gave them out as loan to their needy

customers. These customers were charged fees as though they actually deposited the gold or silver coins. This was done relying on the principle of fractional reserves i.e. only a fraction of the cash deposited is being kept as reserves to meet individual withdrawal demands from the customers/depositors. When goldsmiths/ bankers began to give loans to deficit units, their function as financial intermediaries can be seen to be complete. Banks collect excess funds from units that do not need them currently and then channel the funds to deficit units. More importantly, banks are able now to grant loans that are far in excess of the deposits they have collected.

Having said that, interest paid to depositors and interest charged upon fund users is rather a new institution. For centuries ago, interest charges were illegal in England. One of the reasons that led to the expulsion of the Jews from England at that time was the issue of interest charges. They were alleged to have imposed very high lending rates. Only in the year 1545 was the imposition of interest charges legalised in England. The 1545 Act, however, tried to ensure that interest charges were not excessive, by fixing the rate at 10 percent per annum.

On the other hand, the issue of *riba* was an old religious issue not only in Islam but also in Judaism and Christianity. The position of *riba* was condemned by all these religions which are Divine in origin. Therefore, it is not surprising that the religious sentiment against the practice of riba has been negative from the very beginning. In Islam, *riba* was categorically prohibited through both the *Qur'an* and the *Sunnah* of the Prophet leaving no room for any contrary or reverse opinion. These *Quranic* and *Sunnah* injunctions, as will be later discussed are clear and definite on the prohibition of *riba*. The final and ultimate prohibition of *riba* took place during the lifetime of the Prophet (PBUH) and therefore, it was dated back to 6th century of the Christian calendar.

Interestingly enough, the prohibition of *riba* in Islam during the lifetime of the Prophet (PBUH) passed over four different phases and stages. The manner of this Divine prohibition was precisely similar to the manner where the wine drinking was ultimately prohibited. The most obvious reason that could be inferred from this phenomenon was that the practice of both wine drinking and taking and charging *riba* was so deeply rooted in the pre-Islamic period that it needed a kind of gradualism to prepare the people to accept the final prohibition.

The first revelation was in Mecca which emphasized that, while riba deprived wealth of Allah's blessings, charity (*sadaqah*) raised it manifolds. The verse (al-Rum : 39) reads to the effect; " That which you give as interest to increase the people's wealth increases not with Allah ; but that which you give in charity, seeking the countenance of Allah, multiplies manifold". The second revelation, which was revealed in the early Medinan period, severely disapproved of *riba*, in line with its prohibition in the previous scriptures. It placed those who took *riba* in juxtaposition with those who wrongfully appropriated other people's property and threatened both with severe punishment from Allah. Verse 161 of the Chapter of *al-Nisa'* reads to the effect; *"And for their taking interest even though it was forbidden for them, and their wrongful appropriation of other people's property, we have prepared for those among them who reject faith a grievous punishment".*

Subsequently, around the second or third year of Hijrah, the third revelation was revealed enjoining Muslims to keep away from *riba* if they desired their safety and prosperity in both this world and Hereafter. The third revelation which is consisted of three verses (130-131) from the Chapter of *al-'Imran* read as follows; *"O believers, take not double and redoubled interest, and fear Allah so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey Allah and the Prophet so that you may receive mercy".* Ultimately, the final revelation concerning *riba* was revealed just before the demise of the Prophet (PBUH). The final revelation, comprising of more than one verse, severely censured those who take *riba*, established a clear distinction between

> trade and *riba*, and required Muslims to annul all outstanding *riba*, instructing them to take only the principal amount, and forego even this in case of the borrower's hardship. These meanings are extracted from verses 275-281 of the Chapter of *al-Baqarah* that read to the effect: " Those benefit from *riba* shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: *"Trade is like interest" while Allah has permitted trade and forbidden riba. Hence, those who have received the admonition from their Lord and desist, shall be pardoned for the past; their case is to Allah (to judge) but those who repeat (the offence) are companions of the fire and they will abide therein for ever."* (275) *" Allah will deprive riba of all blessing, but will give increase for deeds of charity for he loves not the ungrateful sinner." (276) " Those who believe, perform good deeds, establish prayer and pay the zakat, their reward is with their Lord; neither should they have any fear, nor shall they grieve."* (277) *"O believers, fear Allah, and give up the riba that remains outstanding if you are believers." (278) " If you do not so, then be sure of being at war with Allah and His Messenger. But if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it" (279) " If the debtor is in difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you realise." (280) " And fear the Day when you shall be returned to the Lord and every soul shall be paid in full what it has earned and no one shall be wronged."* (281)

As for the *Sunnah* of the Prophet (PBUH), there are numerous *hadiths* pertaining to the prohibition and condemnation of *riba*. There is, *inter alia*, a *hadith* recorded on the authority of Jabir that the Prophet (PBUH) cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said: *"They are all alike (in sin)". In another hadith, the Prophet (PBUH) has been reported to have said "Riba has seventy segments, the least serious being equivalent to a man committing adultery with his own mother".*

2.0. DEFINITION OF RIBA

Literally, *riba* means increase, addition, expansion or growth. It is to be noted however that not every increase or growth is prohibited in Islam. The basis of the prohibition is related to the manner through which an addition is gained. Therefore, it was the task of the Prophet (PBUH) to explain how *riba* could take place in commercial matters because otherwise, the *Quranic* injunctions that were previously quoted would be meaningless as the explanation of *riba* was never provided in the *Qur'an*. Before we proceed further, it is relevant to note that many contemporary books and articles on *riba* have misled readers on the meaning of *riba*. Most of the books or articles simply define *riba* as 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 its maturity. Equally popular is an attempt to define *riba* as an excessive rate of premium imposed on the borrower in loan transaction.

The above attempts are not totally wrong but they lack the precise definition of *riba*, a fact that might likely mislead the readers to infer something which is baseless from Islamic law perspective. For example, one may induce that *riba* is only limited or confined to loan transaction i.e. money which is exchanged for money for an extra counter value or consideration. Likewise, one may infer from the qualification of "an excessive rate" that a fair or a reasonable rate of premium or additional payment may be deemed lawful because it is not excessive.

The right approach however, is to look at the source from which *riba* originated. As *riba* was widely practised in the time of the Prophet (PBUH), the explanatory reports of the Prophet (PBUH) will be of paramount importance and relevance. The most comprehensive report on this matter is the *hadith* reported on the authority of 'Ubadah b. al-Samit that is, *"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal, and hand-to-hand. If the commodities differ, then you (may) sell as you wish provided that (the exchange) is hand-to-hand".* This *hadith*, it is respectfully

submitted, offers a very precise and accurate definition of *riba* that is easy to understand and appreciate. It will be shown later that the criterion is not related to any specific rate or manner of extra payment because otherwise the understanding on *riba* would be uncertain, as the rate and manner of *riba* are open to variation. The above *hadith* introduces two elements which, from Islamic legal theory perspective, qualify to constitute the *'illah* i.e. cause or reason of a ruling (known *as ratio decidendi* in English common law). These two elements are gap or deferment in the time of exchange and different counter values in the exchange of two similar *ribawi* items. Put it differently, these two elements are time factor as well as the quantity factor.

The explanation of the above theory is as follows. The Islamic law defines *riba* in two perspectives that are *riba* by virtue of deferment in the time of exchange, known as *riba al-nasiah* and *riba* by virtue of excess in terms of the quantity of one of the countervalues, known as *riba al-fadl*. If gold is exchanged for gold, then the exchange must comply with these two factors, namely it must be of spot exchange and of equal quantity. Should the exchange lacks the first element, it amounts to *riba al-nasiah*. However, if it lacks the second element, it falls under the category of *riba al-fadl*. It goes without saying that should the above transaction is lacking of these two conditions together, then both *riba al-nasiah* and *riba al-fadl* would be jointly applicable. Having said that, the basis of *riba* in Islam is still time of exchange and quantity considerations. The same explanation isrelevant to other commodities and items listed in the *hadith* if they are exchanged for one another i.e. wheat for wheat and so on and so forth.

One may question the validity and the basis of the above theory. Therefore, it is more than appropriate to shed some light on the mechanism of law finding process in Islamic law to show that Islamic law has been always consistent, logical and rational. To ensure the rationality as well as consistency of Islamic law, Allah Almighty, the Lawgiver, has always furnished signs in the *Qur'an* and the *Sunnah* from which the Muslim scholars might find guidance to understand

and elaborate the laws intended by the Lawgiver. This applies to almost all areas of law in Islam particularly in commercial transactions. The central element of both rationality and consistency in Islamic law is the discussion of *'illah* or *ratio decidendi* and how this ratio being extended to cover new cases not textually pronounced or prescribed in both the *Qur'an* and the *Sunnah*. The later process known as ratiocination. However, before one could apply ratiocination, it is crucial to be able to identify the accurate legal cause intended by the Lawgiver in a given ruling or situation.

Generally speaking, there are five features of a valid legal cause in Islamic law. A cause in Islamic law must meet at least all of these five features before it could qualify to constitute a legal cause of a particular ruling. In the case of *riba*, we are already aware of the Divine ruling prescribed upon the practice of *riba* that is forbidden (*haram*). However, at this stage at least, we are uncertain of what actually renders the practice prohibited. Is it the rate of the premium or is it the type of the commodity involved or is it the manner of imposing the premium or is it simply the disunity in time of exchange or is it the inequality of two counter values? Obviously, one or all of the above propositions could be relevant. Is there any indication to help us to be more certain on the position of law in this regard? The answer is in affirmative.

It is in this context that the features of a valid cause shall be helpful. These five features are evident attribute, constant and regular attribute, extensible attribute, an attribute that is co-extensive and an attribute that is co-exclusive. As for an attribute that is evident, it should be ascertainable and perceivable through human senses. Hidden considerations such as intention, consent, good will, just and fair, etc., are not to be considered as an accurate legal cause since they are not ascertainable. The legal cause for a valid contract, for example, is the offer and acceptance (*ijab wa qabul*) rather than the buyer's and seller's actual consent, simply because consent is imperceptible. Since the offer and acceptance are evident, they qualify to become the legal cause for a valid

contract. Thus, an attempt to consider certain rate of interest as a determining point in *riba* is meaningless as the attribute of being excessive or otherwise cannot be perceived. Following this explanation, one can conclude that any definition that tends to associate *riba* only with excessive charges on the use of financial resources is not acceptable. The rate charged is irrelevant in *riba* discussion.

Next, the legal cause must also be a constant and regular attribute that is applicable to all cases without being affected by the differences of persons, times, places and circumstances. In the case of concession granted to travelers to brake the fast during the daytime of *Ramadan*, it has established that the legal cause was the journey itself, as it is constant and regular. An attempt to base this ruling on the consideration of difficulty faced by travelers will be wrong as difficulty differs from one person to another not to mention variation caused by different times and places. There are many scholars who argue that, while *riba* is prohibited in consumption loan, it is allowed in productive loan. Again, this argument is invalid because the legal cause proposed is variable according to the nature and purpose of loan. In other words, people may agree on the nature of loan on one occasion but they may not be able to agree on this issue on other different occasions.

The third element is that the legal cause should be transient or extensible. Should the legal cause be inextensible i.e. not transferable to other similar cases, the legal cause is lacking one of the features of a valid legal cause. Next, the legal cause should also be co-extensive in a way that whenever the legal cause exists, the rule of law will also exist. Last but not least, the legal cause should also be co-exclusive i.e. if the legal cause does not exist, the rule of law will also not exist.

It seems that the elements of time and quantity are compatible to all these features. Accordingly, *riba* will take place even if the rate is so minimal as there

is inequality in one of the counter values. This definition takes into consideration neither the purpose of loan nor the rate of interest imposed on borrowers. Thus, the meaning and application of *riba* will be obvious, constant and fixed throughout centuries. No one will find difficulty in ascertaining the concept and meaning of *riba* as the determining point is very structured. This is the very essence of the *hadith* of the Prophet (PBUH) that was quoted earlier. As such, *riba* cannot be simply defined in one or two sentences, as its definition must incorporate *ribawi* items, inequality of counter values and disunity in the time of the exchange. Therefore, the most comprehensive definition, to the best of the writer's knowledge, is Nabil Salih's definition. He notes that " *Riba* in its *Shari'ah* context, can be defined, as generally agreed, as an unlawful gain derived from the quantitative inequality of the counter values in any transaction purporting to affect the exchange of two or more species which belong to the same genus and are governed by the same legal cause. Deferred completion of the exchange of such species, or even of species which belong to different genera but are governed by the same *'illah* (legal cause), is also *riba*, whether or not the deferment is accompanied by an increase in any one of the exchanged counter values". We may add that *riba* also includes both inequality of the counter values and deferment in exchange together as in the case of modern *riba*. In modern time, loan is lent out for an extra repayment to be settled sometime in the future. Thus, it involves both quantity and time factors.

3.0. TYPES AND CLASSIFICATIONS OF *RIBA*

Types and classifications of riba could be inferred from the *hadith* reported on the authority of 'Ubadah b. al-Samit that is *"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt- like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand".* In this *hadith*, the Prophet (PBUH) has indirectly classified riba into two classifications. The first riba is known as *riba al-fadl* i.e. *riba* by excess, and this has been represented by the Prophetic wording of " *sawaan bi sawain*" that is like for like or equal for equal.

This type of *riba* is alternatively or interchangeably known as *riba al-buyu'* (*riba* in barter trading) and *riba al-Sunnah* respectively.

There are two questions that arise from this *hadith*. The first is about why only six commodities have been specified; and the second is why exactly the same reciprocal payment is required. Of the six commodities specified in the *hadith* about *riba al-fadl*, two unmistakably represent commodity money whereas the other four represent staple food items. The scholars have agreed that all commodities that are used as money i.e. acts as medium of exchange, store and measure of value, are to be treated as *ribawi* or usurious items. Therefore, they must be treated on the basis of equal to equal and hand-to-hand when they are exchanged for each other. As for the last four items, the scholars have disagreed on the legal cause underlying these commodities. Briefly, the Shafi'is maintain that the last four items are usurious items because they are edible. Unlike the Shafi'is, the Hanafis contend that the legal cause is the quality of those articles as being saleable by the measurement of weight or capacity. Yet another view belongs to the Malikis suggests that the legal cause is the fact that those items are main food and preservable. By applying analogy, the coverage of usurious items will be extended to cover other items that share the common legal cause according to respective schools of law.

The second question that is more interesting is the logic of the requirement of equal to equal in the exchange of two similar *ribawi* counter values. On the surface it appears hard to understand why anyone would want to exchange a given quantity of gold or silver or any other commodity against its own counterpart and that too will be transacted on spot basis. What is essentially being required is justice and fairplay in spot transactions involving barter trading. Anything that is received as "extra" by one of the two parties to the transaction is *riba al-fadl* i.e. all excess in barter trading over what is justified by the counter value. To ensure justice, the Prophet (PBUH) even discouraged barter transactions and asked that a commodity meant for an exchange of the same

commodity to be exchanged first against cash and the proceeds be used later to buy the needed commodity. This is because in a barter transaction the equivalents may be established only approximately thus leading to some injustice to one or the other party.

The second classification refers to *riba al-nasi'ah*. The term *nasi'ah* comes form the root *nasa'a* which means to postpone, defer, or wait. It is also known as *riba* of loan and *riba al-Qur'an* respectively. It might be for this reason that many scholars have wrongly defined *riba al-nasi'ah* as fixing in advance of a positive return on a loan as a reward for waiting or postponement of repayment time. Based on our analysis, *riba al-nasi'ah* does not necessarily involve any additional payment in lieu with the postponement of repayment of a loan. This, in fact, refers to a case which comprises of both *riba al-fadl* arising from extra payment and *riba al-nasi'ah* caused by deferment given to borrower to repay the loan. *Riba al-nasi'ah* takes place when the exchange of two similar ribawi items is effected not simultaneously even for equal counter value e.g. 1 kg of wheat for 1 kg of wheat but not simultaneously transferred.

4.0. RATIONALE AND RAISON D'ETRE OF THE PROHIBITION OF RIBA

The question of the rationale of the prohibition of *riba* is a very delicate and complicated topic as people have already accustomed to practising *riba*. Furthermore, no one can easily and simply deny the remarkable contribution of *riba*-based banking system to the development of our modern society. Development cannot be achieved, as it has been widely propagated, without the role of the financial intermediaries i.e. banks. On the other hand, banking institutions have been established on the principle and doctrine of *riba*, namely paying interest to depositors and charging interest on borrowers. The bank's profit are mainly attributed to the difference between interest expended (paid) to depositors and interest earned (received) from borrowers. However, the topic of this nature would be very much elementary and easy once the negative impacts

of *riba* started to upset the people. At that time, explanation of the evils of *riba* would be irrelevant and useless, as the impact would be very damaging to the society. It is in the light of this damaging effect of *riba*, Allah Almighty has already warned the people to avoid practising *riba* because the opposite attitude has been described by Allah Almighty as declaring a war against Allah and His Messenger. Obviously, the outcome and aftermath of this phenomenon would be unimaginable and beyond repair.

Having said that, it is still relevant to highlight on some of the evils of *riba* that would inflict on a society that practices *riba* in its financial activities. The present explanation is not meant to be exhaustive simply because the result of violating the Divine prohibition of *riba* cannot be quantified. On this, one can clearly see that Allah Himself did not prescribe any kind of specific punishment on both the payers and receivers of *riba* as Allah did in the case of wine drinking and other capital punishments in Islamic law. The purpose of this, it is respectfully submitted, is for Allah Almighty to take people by surprise should they continue practising *riba* because the impact of *riba* is widespread and far-reaching. That is to say that while other offences might subject a few people in the society to suffer, *riba* would subject almost all people into some kind of crisis and problem. Therefore, it is the duty of the public at large to prevent this before it occurs. The people cannot blame except themselves should this problem renders their life abhorrent and awful.

Before we proceed to discuss the rationale behind the prohibition of *riba*, it is interesting to understand the philosophy of Islamic law with regard to the criterion of considering a particular practice lawful or otherwise. Al-Shatibi, a great Muslim jurist, has observed through induction process that the status of prohibition given to a particular practice does not necessarily imply that the said practice is void of any good and meaningful elements that are beneficial to mankind. Likewise, what is permitted or made obligatory in the eyes of the religion does not necessarily suggest that the permitted or obligatory practice is free from any bad

things that might be harmful to mankind. However, the ultimate criterion is the degree of each of good and bad elements embodied in a particular practice. Should the good elements supersede and overwhelm the bad elements, the practice is qualified as permitted or obligatory as the case may be. The reverse phenomenon would render the practice to be deemed as either disliked or forbidden as the case may be. An excellent example could be found in one of the Quranic verses pertaining to the prohibition of wine drinking i.e. at an early stage of its prohibition. The verse (*al-Baqarah*: 219) reads to the effect; "They ask you concerning wine and gambling. Say: In them is great sin and some benefit but the sin is greater than the benefit". The wine was ultimately prohibited although the wine, up to modern time, might have contained some benefits for people as normally discussed in the discipline of medicine.

At this point, one may have a valid reason to question the logic of this philosophy upheld by Islamic law. There are many answers that could be given to answer this query. However, it is sufficient to note one interesting response given by al-Shatibi himself. He emphasised on the fact that people are created by Allah Almighty to be tested whether they are obedient to Him Almighty or otherwise. The meaning of this test cannot be achieved if all the practices are either good or bad completely because people would then be naturally inclined to observe what is good and to avoid what is bad. In other words, as there is no conflict of desire and inclination, one cannot be tested. However, once a practice contains both good and bad elements, one can now be tested whether to follow what is already prescribed upon oneself or what is more appealing to one's whim and desire and therefore rejecting the Divine order. This fact is relevant to all prescriptions in Islamic law irrespective of whether they are of prohibitive or obligatory in nature.

As for interest, it does contain good elements because otherwise nobody would be willing to practise *riba*. Obviously, it gives an advantage to people with surplus of money to receive the premium on their money lent out to people faced with deficit of money. This has been extensively discussed by the exponents of

riba under a few theories such as 'preference theory', ' theory of rent of money' and the like. In a more specific financial analysis, interest has been deemed as the most powerful factor in the process of flow of fund. It lubricates financial intermediation in the process of fund flow. It is the interest rate that attracts and encourages financially surplus units to hold their excess fund in the form of financial instruments. Therefore, the interest rate is the primary incentive that encourages savings with financial institutions. On the other hand, as costs of funds, interest rate allocates the relatively scarce financial resources among the deficit units. As cost of funds, it can be said that the interest rate system imposes a form of financial discipline on entrepreneurs who borrow funds to finance their projects. Interest charges forces entrepreneurs to be thrifty and to run their business efficiently. Consequently, the entrepreneurs have to take all necessary measures to ensure that their targeted profits can be achieved to be able to repay the loan plus the interest charged on the principal sum of loan. This form of financial discipline is similar to that of the market forces that reward those who are efficient and successful.

Looking at the interest system from government or regulator's point of view, it may said that the interest rate is very much influential in many respects. First, as to mobilise funds for national social economic development, the government issues debt instruments and encourages the public, both individuals and institutions to hold national debts. At the same time, through the Central Bank, the government varies the interest rate as a means to control the level of liquidity and supply of money. Through controlling the supply of money, it is hoped that the level of economic activity in the country can be influenced and sustained. In addition, the interest rate is also used to regulate commercial banks, especially their abilities to create credit.

It is against this backdrop that we shall now present the Islamic perspective on why *riba* is and shall be prohibited once and for all. In one of the *Quranic* verses quoted earlier on the position of *riba* in Islam, Allah Almighty has commanded the

riba receivers, upon their repentance, to take back the principal and to do away with the interest or additional charges on the principal. By so doing, neither they inflict injustice on *riba* payers nor riba payers being oppressed. This is the very essence of verse 279 of *al-Baqarah* that is; "But if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it". Therefore, the central theme and rationale of the prohibition of *riba* is injustice. However, the question may arise as "in what sense *riba* in unjust?" and "does justice really matter in commercial transaction because other lawful transactions such as sale and lease contracts may have also contained the element of injustice, for example, in pricing?" These are some of peculiar questions that one has to redress sufficiently otherwise the prohibition of *riba* would be always susceptible to suspicion and perplexity.

We may begin by saying that the undesirable features of *riba*-based banking system, looked at in the context of the operative principles that currently underlie conventional banking practice, may be listed as follows:

(i) Transactions based on interest violate the equity aspect of economic organisation. The borrower is obliged to pay a pre-determined rate of interest of the sum borrowed even though he may have incurred a loss. Even when a profit is made, the fixed rate of interest can prove an onerous burden if the rate of profit earned is less that the rate of interest payable.

(ii) The inflexibility of an interest-based system in a loss situation leads to a number of bankruptcies resulting in loss of productive potential and unemployment.

(iii) The interest-based system is security oriented rather than growth oriented. Because of their commitment to pay a pre-determined rate of interest to depositors, banks in their lending operations are most concerned about the safe return of the principal lent along with the stipulated interest. This leads them to confine their lending to the already well established big business houses or such parties that are in a position

to pledge sufficient security. If they find that such avenues of lending are not sufficient to absorb all their investible resources, they prefer to invest in government securities with a guaranteed return. This exaggerated security orientation acts as a great impediment to growth because it does not allow flow of bank resources to a large number of potential entrepreneurs who can add to the gross national product by their productive endeavour but do not possess sufficient security to pledge with banks to satisfy their criteria of creditworthiness. Oversupply of credit to well established parties and its denial to a large segment of the population also results in increasing inequalities of income and wealth.

(iv) The interest-based system discourages innovation, particularly on the part of small-scale enterprises. Big industrial firms can afford to experiment with new techniques of production as they have reserves of their own to fall back upon in case the adoption of new practices does not yield a good dividend. Small-scale enterprises hesitate to go in for new methods of production with the help of money borrowed from banks as the liability of the banks for the principal sum and interest has to be met irrespective of the results while they have very little reserves of their own. This not only acts as an impediment to the rate of growth but also aggravates income inequalities.

From a legal perspective of Islamic commercial law, *riba* is deemed as wrongful appropriation of other's property. The basis of this ruling is taken from the theory of transfer of property in Islamic commercial law. It has been observed that a property, be it cash/capital, tangible asset, services and the like that belong to one's party cannot be transferred to another except following one of the 'contracts' below:

(i) property earned by one party as result of the combination of one's individual creative labour and entrepreneurship or natural resources or capital as the case may be. This could be partly seen in various forms of partnership in Islamic law ;

(ii) property whose title has been transferred by its owner as a result of bilateral exchange such as in the contracts of exchange e.g. sale, debt settlement by contra transaction (*muqasah*), etc.

(iii) property whose title has been transferred by its owner by virtue of remittance of rights of others in the owner's property such as in case of rebate granted for early settlement of any financial obligation (*ibra'*), etc ;

(iv) property whose title has been transferred by virtue of donation and grants by the owner/donor such as in the contract of gratuity e.g. gift (*hibah*), endowment (*wakaf*), will (*wasiyyat*) etc; and

(v) property transferred from one hand to another following the law of inheritance.

This theory of transfer of property in Islamic law provides no room for lending activities based on interest because interest is an income claimed outside the legitimate framework of the Islamic theory of the transfer of property from one hand to another. Therefore, income or yield earned from *riba* activities is non-halal because Islamic law does not approve the mechanism of earning this income.

The writer however is much more inclined to elaborate the evils of *riba* from the perspective of wealth creation and wealth transfer. The treatment of the rationale of *riba* from this perspective, it is respectfully submitted, will satisfy both economic and legal justifications on the prohibition of *riba*. The entire Islamic commercial law aims at promoting the actual wealth creation instead of artificial and 'bubble' creation of wealth. On the other hand, wealth creation alone without wealth transfer will not benefit the society at large. Likewise, wealth transfer without wealth creation will not bring benefit to the society. If mankind were to engage solely in wealth transfer processes, the stock of wealth could not be maintained let alone increased. Wealth creation is therefore fundamental to the survival of mankind. Therefore, one must be able to differentiate, for example, the activities of gambling on one hand and farming on the other. Although both

activities employ resources and people, it is farming that produces the food that allows man to live whereas casinos simply transfer wealth from losers to winners without creating new stock of wealth.

The above argument applies to lending activities with a stipulated rate of interest. *Riba* activities do not create new stock of wealth. Instead, they lead to the transfer of the wealth from one party to another i.e. from borrower to lender. No direct new stock of wealth is created in that process. Islamic law has been always emphasising on both wealth creation and wealth transfer. In Islam, a growth in wealth cannot always be inferred from the making of an accounting profit, and that an accounting profit does not always arise from a growth in wealth. The existence of one does not necessarily signify the existence of the other. Obviously, this is no direct wealth creation and wealth transfer in *riba*-based lending activities. If there is any, it is solely for the benefit of the lenders or capitalists.

One may argue that *riba*- based lending activities have actually benefited the society, both individuals and institutions. This is partly true because those lending activities have not only benefited the lenders but also the borrowers in meeting their financial needs. Also, profit earned by financial institutions is in part used to pay salaries and thereby allow employees to enjoy life. As for the shareholders of the banks, they will also benefit of the income earned. Surely then, one may further argue, that the *riba*-based lending activities cannot be zero value-added. This argument is again dubious as *riba*-based lending activities always guarantee fixed income to the lenders. Not only that, the lenders bear no risk whatsoever in this process. Ironically, this situation is more ugly and sinful than gambling simply because in the latter activity, both the winners and the losers are equally exposed to chance and risk. In other words, interest is a zero-sum game, where one person gains at the expense of another.

The practice of riba is made possible by considering money as commodity. In contrast, Islam never recognised money as commodity. Money has been viewed and perceived in Islam as medium of exchange, store and measure of value. Based on this principle, it has been noted that Islamic banking and finance cannot deal with money directly to generate income or profit. On the contrary, Islamic banking and finance could generate the profit through either commodity transaction or combination of both capital and effort i.e. partnership. Money, in Islam, does not earn money without collaboration between capital and effort. In Islamic law, benefit or profit accruing to one party out of bilateral contracts must be always justified on the basis of one's exposure to some degree of risk and liability.

The principle that associates profit with liability has been widely accepted by Islamic law and later incorporated in the *Majallah al-Ahkam al-'Adliyyah* (The Civil Law Code of the Ottoman Empire which was codified in 1876) in three articles respectively. Article 85 of the Majallah states that "the benefit of a thing is a return for the liability for loss (arising) from that thing". Article 87 highlights that " the detriment is as a return for the benefit". Finally, article 88 explains that "the burden is in proportion to the benefit, and the benefit in proportion to the burden". Therefore, in any single transaction that could potentially create an advantage or benefit to one party or both parties to a contract, the benefit he will be receiving should be met with a corresponding possibility of risk and liability even momentarily or so minimal to justify the benefit he will earn out of that transaction. This principle, in addition to the theory of transfer of property, could draw a line between interest which is unlawful and profit which is lawful since benefit in lending activities, unlike in trading or partnership, does not commensurate with the liability of the lender/creditor.

To conclude, we must reiterate that Islam always looks at both wealth creation and wealth transfer as fundamental issue to the development of the society. Actual wealth creation and wealth transfer will necessarily benefit the large

segment of the society if not the whole society. Trading activities, for example, may benefit not only the buyers and suppliers or sellers but also other sectors related to business activities such as transportation, marketing, storage, packaging, advertisement, legal personals, etc. Interestingly enough, each of these sectors will be expanded to cover many other related activities. Therefore, transportation for example, may involve workforce such as drivers and assistant drivers, vehicle for transportation, road tax of the vehicle, vehicle maintenance and so on and so forth. The need for vehicle will later create demand on vehicle production. The sequence of needs and accessories will never end to the extent that ultimately, each and every individual in the society will be benefiting from this wealth creation and wealth transfer. Perhaps, the Gross Domestic Products (GDP) of this society will now be reflecting the actual value of new wealth produced in the domestic economy over a given period of time.

On the other hand, we can easily observe that it is the trend of modern government to raise the fund from the public by issuing notes and bonds. The holders of the notes and bonds are promised with a fixed return that is based on interest rate. Unfortunately enough is that the majority of the expiring debts are paid with the issue of new debt instruments. In this situation, there is wealth transfer but new wealth is never created to replace the old wealth. As a result of interest payment, most governments are forever in debt. This may lead to two worrying possibilities. First, long-term government debts burden the future generations of the society. If a government is spendthrift and finances most of its expenditures by issuing long-term government securities, future generations will have to bear the cost sand responsibility of repaying those borrowing in debt instruments. Second, which is more alarming is that it may lead the country into a debt crisis. Large-scale borrowing based on optimistic prospects, an unexpected increase in interest rates, coupled with a sharp fall in the prices of primary commodities may subject some developing countries to experience the financial crisis that affects the whole country. Should the fund be raised through Islamic equity financing or at least through Islamic debt securitisation the above problems could be avoided.

5.0. INTEREST-BASED PRACTICES IN CONVENTIONAL BANKING

Obviously, conventional banking has been established in Malaysia since early this century. By now, it has captured most of the market both in deposit and in financing sides. Banking services are various. In the financing side, it covers all types of loan for all purposes of financing be it for housing loan, trade financing, personal and consumer loan, education loan, hire-purchase, project financing, overdraft, share financing and so on and so forth. As for the deposit, it has peculiar accounts of saving account, current account as well as fixed deposit. Although the number of banking services and products are many, they all operate on one simple mechanism that is interest-based. The entire activities is to advance loan to qualified customers to satisfy their financial needs whether to purchase a house, a car or to import goods from overseas and the like. The bankers are credit analyst experts as their task is simply to ascertain the financial ability of the customers to repay the principal plus the stipulated interest. The documentation drafted by the banks are then tailored made to suit the loan advancement and perhaps the security or collateral. The position of commodity is not an issue except when it is used as a security in some of loan arrangements.

Therefore, one may conclude that even though the conventional banking system looks complicated, it is not as complicated as interest-free banking system. The main assignment of conventional bankers is to intelligently manage the fund provided by the depositors. The key element of this management is interest rate paid to depositors and interest rate charged on customers. In other words, conventional banks pay a fixed rate of interest to their depositors and charge the fund users another fixed, though higher, rate.

6.0. SOLUTION TO INTEREST-BASED TRANSACTIONS

At this stage, it is relevant to note that every system is influenced by its own worldview which, in turn, is based on a set of implicit and explicit assumptions about the origin of the universe and the nature purpose of life. This worldview

controls the nature of man's reflection on almost every subject. Differences in view about human nature would lead to differences in conclusions about the purpose of human life, the ultimate ownership and the relationship between fellow men with regard to rights and liabilities. The conventional banking system was not the product of our culture. It was inherited or assimilated evolutionally from the Western secular system. Therefore, the characteristics of western-secularist principles of wealth creation and wealth transfer or allocation will likely influence the activities of any institution following the framework.

Unlike interest-based system that is a zero-sum game, Islam promotes or encourages positive-sum game where all parties gain or at least there is a possibility of gain and loss on both parties. This may take the form of both equity and debt financing that assumes a certain degree of risk and liability to justify the lawfulness of income or yield earned from those transactions. As equity financing is yet to develop in Malaysia and elsewhere, Islamic banking in Malaysia and elsewhere has resorted to contract of exchange as the most common and the best accommodative mode of mobilising funds under Islamic finance framework. As a result, various innovative Islamic instruments based on the contract of exchange found their way into the Islamic financial market both at primary and secondary market. These include bay' *bi thaman ajil* (deferred payment sale), *murabahah* (mark-up sale), *ijarah* (leasing), *ijarah thumman al-bay'* (Islamic hire-purchase) and *bay al-dayn* (sale of debt).

In addition, Islamic banking has also explored the contract of security to mobilise the funds and the present product available is based on *hiwalah* (transfer of debt). Needless to say that Islamic banking has also maintained the contract of services such as Letter of Guarantee based on *al-kafalah* contract, fees for money transfer and the like.

Having said this, it is the writer's submission that Islamic banking has the potential to become successful financial institution if it is prepared to venture into

equity financing along with debt financing. The area of equity financing is an area that conventional banking have been declined to enter. Perhaps, if the Islamic banking were to venture into *mudarabah* and *musharakah* financing with some modifications necessary to minimise the risk on the part of the bank, it will create a new chapter in the history of banking.

7.0. THE WAY FORWARD

Islamic banking products are both religiously appealing and financially viable. For some people, the religious commitment will be good enough to guide them to take up Islamic way in both investment and financing. However, for the other group, they deserve a very convincing explanation and clarification on the beauty of Islamic banking from a purely financial perspective. From management point of view, Islamic banking could be considered as a mode of diversification that is very much relevant in banking discipline. Diversification has been proven to be the best method to manage the risk. Perhaps, the time will come that Islamic banking will become more dominant as Islamic banking, ideally speaking, is not merely a product but a system that guides the society on both wealth creation and wealth transfer.