

## Islamic Banking

### Fulfilling the *Maqasid al Shariah* - the purpose of the Shariah

The concept of Tawhid (Oneness):

- Given that Islam is wholistic, Islamic law is derived primarily from Divine and religious sources and encompasses all aspects of man's life. The sources are namely the the Holy Quran and the Sunnah of the Prophet Mohammad. The Shariah falls under two categories, namely, those pertaining to faith and worship (ibadat) and those that deal with man's relationships within the society such as family and commercial transactions (muamalat). The key to the Islamic economic philosophy is man's relationship with Allah, His universe and His people and the nature and purpose of man's life on earth. Man's relationship with Allah is defined by tawhid (oneness of God) which essence is the total commitment to the will of Allah, involving both submission and mission to live human life in accordance with His will whereby His will is the alpha and the omega of human endeavour. All assets in the universes belong to Allah, man is only a trustee with rights to economic activities provided he does not encroach on the rights of others. Hence, the values that emanates from this economic philosophy are such as iqtisad (moderation), adl (justice), ihsan (kindness par excellence), amanah (honesty), infaq (spending to meet social obligations), sabr (patience) and istislah (public interest). Similarly, there are a number of values which are negative: zulm (tyranny), bukhl (miserliness), hirs (greed), iktinaz (hoarding of wealth) and israf (extravagance). Hence, muamalat and economic activity has to stay within the positive parameters of halal and distribution has to be adl (just). These concepts present an Islamic economic framework for the exercise of commercial activities.
- Given that all wealth and property belong to Allah, and man is only the appointed trustee to use the resources for the good of mankind, man therefore has the obligation to contribute a portion of his gain towards zakat and to ensure that the resources are passed to the next generation in good condition through the system of inheritance. The wealth and the endeavours of man is to be utilized positively in fulfillment of his responsibilities to Allah to uphold the Maqasid al Shariah as explained by Imam Shatibi as follows :
  - Haq al din – the duty to respect the Divine source of truth to guide human thought and action, the recognition and acceptance of Allah and the responsibility of applying the tenets of the Holy Quran in all aspects of human life. This duty provides the foundation for the following six responsibilities.
  - Haq al nafs or Haq al ruh - the duty to respect the human person. This includes respect for life, Haq al haya.
  - Haqq al nasl which is the respect the nuclear family and the community at every level to the right of the individual.
  - Haq al mal - the duty to respect the rights of private property in the means of production which requires institutions to broaden access to capital ownership as a universal human right and as an essential means to sustain respect for the human person and human community i.e. right to pursue economic interests.
  - Haq al huriya – the duty to respect self-determination of both persons and communities through political freedom as economic democracy is a precondition for the political democracy of the nation.
  - Haq al karama – the duty to respect human dignity.
  - Haq al 'ilm – the duty to respect knowledge, an encouragement of freedom of thought and assembly in order for man to seek knowledge wherever he can.
- The rights that are related to Islamic finance stem from Haq al mal. Out of this is a key right which is to pursue economic interests. This right is an obligation and a duty to Allah and one which man cannot abrogate so long as he has the ability to do so. Contrary to popular belief, self interest is not negated in Islam. A man's rights are not negated even if he has no ability to make good of his rights. It is only negated if he is able to fulfill those rights but does not do so[1]. It is in the pursuit of self interest, materially, temporally and spiritually, that man should comply with the Shariah. By virtue of the Shariah law, the duty of all Islamic parties to the contract is upholding amanah, as follows :
  - accountability to Allah, and,
  - accountability to himself, his customers and partners within the Shariah framework.

- Hence, the rights of the individual is given co-protection by one another through the concept of amanah which forms a strong foundation for the development of business and economic transactions.
- In fulfilling the Maqasid al Shariah, man inadvertently fulfills not only his social and ethical needs but also his commercial needs as well. There lies the wisdom of Muslims having to “fulfill all obligations” as in doing so, mankind is fulfilling one another’s needs and obligations, hence a Win-Win for all. By man’s endeavour to protect Religion, Life, Honour, Intellect and Property in Islamic banking and finance transactions, man’s all three : commercial, social and ethical needs, are balanced and fulfilled.

### **Prohibition of Riba – Why is Riba prohibited?**

Riba in the Economy exists as the following :

- **(a) Riba as Unearned Income**

The idea of usury as unearned income stemmed from the early Church doctrine of what constitutes a just price. Charging interest therefore is like earning money whilst doing nothing, hence, income that was not earned for without effort one does not earn. The Lateran Council of 1515 stated that “This is the proper interpretation of usury when gain is sought to be acquired from the use of a thing, not in itself fruitful (such as a flock or a field) without labour, expense or risk on the part of the lender.” To live without labour was unnatural and Dante was said to put usurers in the same circle of hell as the inhabitants of Sodom and other practitioners of unnatural vice. Similarly, in Shariah, capital has to be invested and returns come with the accompanying risk and business liabilities. Profit is returns after value creation by both parties whereas interest is a fixed cost, not returns. Aristotle argued that “a piece of money cannot beget another.” A musharakah or mudharabah venture would provide the productive investment returns for all the parties concerned and for the economy.

- **(b) Riba as Double Billing**

Money has been argued to be a fungible good, consumable and identically replaceable, for which ownership passes from the lender to the borrower in a loan transaction at a ‘sale’ price. Therefore, to charge interest over the price of the sale is like selling the commodity twice, as proclaimed by Aquinas in Summa Theologiae. Hence, paying interest is not productive to the business venture as the interest paid increases the cost of the venture. Worse is the case where the loan is being used for consumption, this would translate to overpaying for the consumed item. Hence, in actual fact, productivity and value creation would be negated by the amount of interest paid.

- **(c) Riba as Exploitation of the Disadvantaged**

Given that the credit of the poor or financially disadvantaged person or entity is not as good as one that is cash rich, the interest charged towards this person or venture is usually higher than the so called investment grade names. The poorer the credit, the higher the interest spread. Hence, instead of assisting the venture to be economically viable, the interest charge actually worsens the profitability probability of the venture. Interest payment may be so high that it actually erodes the profitability of the venture completely. The same scenario has been proven on a large scale by the Third World’s Debt Crisis whereby poor countries are charged substantial amounts of interest payments which is crucial for their national economic development activities, these interest payments erode the financial viability of the projects and may sometimes derail development altogether. As compounding interest accumulates into principal, the poor country becomes debt burdened by un-repayable interest. The late Pope John Paul II in 1989 declared that “Capital needed by the debtor nations to improve their standard of living now has to be used for interest payments on their debts” and called for debt forgiveness by the OECD countries. Therefore, the Islamic profit sharing and riba-free approach is the most viable solution for economic development, whether for an enterprise or on a national or global scale. The IMF Working Paper on The Role of Domestic Debt Markets in Economic Growth’s empirical studies stated that the cost of domestic debt may rise sharply due to time inconsistency when government’s credibility is low.

- **(d) Riba as Discounting the Future**

Compound interest results in an appreciation in invested monetary capital, however, this appreciation is artificial and accumulatively, on a national scale it brings about inflation. A high activity of future discounting may bring about the depletion of resources (i.e. goods and services) as the growth rate of discounting can exceed the

growth rate of production of the resources. Hence, the later generations are the ones lumped with a deficit in resources as it has been consumed at a discount in advance. The Shariah principle of the prohibition of gharar will prevent this depletion as transactions are traded on a present value i.e. contracted price on the transaction date, hence the value is not being discounted, i.e. shortchanged. The parties to the contract would receive what is due to each equitably, which would contribute to a strong economic industrial base.

- **(e) Riba as a Mechanism of Unequal Distribution of Wealth**

As interest is 'earned' without effort and is hence, a cost, not a revenue, a riba-free transaction would better contribute to the equitable distribution of wealth as the profit and loss sharing partnerships provides a wider base of investors and participants. The more profit sharing ventures are transacted, the wider and deeper will be the number of ownerships and this would provide the base for mark-to-market prices, a free market and ultimately, greater equitable distribution of wealth within the community. This Shariah concept of profit sharing also prevents trade cartels and monopolies by certain organizations or individuals within the community.

- **(f) Riba as an Agent of Economic Instability**

Riba-free ventures promotes unicuity, free markets, private property ownerships, economic efficiency, social and economic justice, no inflation, a money supply that is related to the real economy and an ethical ethos – the ingredients for a stable economy.

### Interfaith view on prohibition of Riba

- The prohibition of riba or usury goes back to the days before the Holy Prophet Mohammad. Usury has been mentioned in Hinduism and Buddhism, the earliest known evidence is the Vedic Texts of Ancient India (2000-1400 BC) in which the userer known as kusidin was described as someone lending with interest. Subsequently, the Sutra Texts (700-100 BC) and the Buddhist Jatakas (600-400 BC) expressed contempt for these moneylenders. Vasishtha, the reknowned lawmaker enacted an anti-usury law which forbade the higher castes of Brahmins and Kshatriyas from being usurers as "hypocritical ascetics are accused of practicing it." By the 200 AD, the sentiments against usury were somewhat toned down as reflected in the Laws of Manu whereby "Stipulated interest beyond the legal rate being against (the Law), cannot be recovered : they call that a usurious way." Hence, the dilution of the prohibition of usury whereby usury is referred to as the portion of interest which is over and above the socially accepted rate, i.e. prevailing market rate.
- Plato considered usury to be contrary to the nature of things, Aristotle disapproved of the money traders' profit, Aristophanes disapproved of it, Cato condemned it as akin to homicide and Plutarch condemned it in his treatise against incurring debts. Whilst these Roman and Greek philosophers and writers condemned usury, Greek and Roman laws regarded consumption loans as gratuitous contracts and allowed a small interest to be charged. The Greek's Law of the Twelve Tables allowed only unciarium fenus, about one twelfth of the capital i.e. 8.33% whereas the Roman's Plebiscitum Lex Ganucia forbade interest altogether. At a later stage, however, as interest taking could not be forcefully controlled, the Romans allowed a maximum of 1% per month interest charge on consumption loans. Julius Caesar, on the other hand, placed a ceiling of 12% on interest charges on loans, a policy adopted by the Democratic party in order to assist the borrowers from carnivorous money lenders. Emperor Justinian later halved the amount in order to assist the poor in his decree Laws of Justinian.
- The Torah as codified in the Talmud also condemned usury practices as either forbidden, discouraged or scorned. The Hebrew term for interest, "neshekh" literally means to bite. The Talmud prohibits the taking of "avak ribit" which means, the dust of interest. However, it allows "rubbit kezuzah", which is interest that has been prior agreed by a borrower and lender in a partnership called "hetter iskah". Subsequently, the Jews practiced usury by inserting a clause of "al-pi hetter iskah" into their loan contracts as a way of evading the prohibition and hence, usury became legalized by man.
- Until the ninth century, canonical decrees forbade the taking of profit on loans but only on clerics. The first of such theological opinion on interest payment was the 44th of the Apostolic Canons and the Council of Arles in 314, followed by the 17th Canon of the First Council of Niceaea in 325. Later, the 12th Canon of the First Council of Carthage and the 36th Canon of the Council of Aix declared it reprehensible for both clerics and layman to profit from money lending. The theological arguments against usury were developed in the Middle Ages in which the Law of God was accepted as the basis for all civil laws[1]. The canonical laws of this time absolutely

forbade usury as reflected in the Decree of Gratian and the Decretals and ordered the return of such profits to the borrowers. In 1179, the Third of the Lateran decreed that persons who accepted interest on loans could not receive sacraments in church nor Christian burials. In 1311, Pope Clement V made usury a heresy and abolished all usury legalizing secular legislation. Subsequently, Pope Sixtus V condemned the charging of interest as “detestable to God and man, damned by the sacred canons and contrary to Christian charity.”[2]

- From the period of the twelfth century onwards, there was an increasing movement away from accepting biblical law as the basis for all human laws. Pro-usury arguments started to surface to differentiate between benevolent loans to the poor and commercial trade loans which deserved profits. John Calvin in a letter to Oekolampadius[3] argued that “there is no scriptural passage that totally bans usury.” The Old Testament prohibited usury in Nehemiah 5:7[4], disallowed it to be charged to the poor (Exodus 22:25)[5] or to a brother or for food (Deuteronomy 23:19)[6] but allowed to strangers or foreigners. Furthermore, all debts had to be cancelled in the seventh year (Deuteronomy 15:1-6)[7] and in the Sabbath year. Debt was seen as a form of slavery in Proverbs 22:7[8].
- Calvin argued that the times, places and the nations must all be taken into consideration before a law is enacted, a move towards abandoning God’s law for natural law[9]. Calvin legalized the charging of a ceiling rate of 5% in Geneva, abrogating the Old Testament for the concept of “equity” proposed in the New Testament. Calvin stated that he was “unwilling to condemn usury so long as it is practiced with equity and charity”[10], meaning, any interest charged must be reasonable and fair. But who was to dictate what equitable interest rates would be? The free market mean of determining equitable prices was to allow free man to make free choices. Calvin’s solution to equitable interest rates was proposed as “whoever borrows should make at least as much, if not more, than the amount borrowed.” However, this solution is not effective as the borrower cannot ensure in any way that his profits, if any, would be at minimum, the amount of the loan. This interest incurred on commercial or trade loans were then referred to as ordinary interest whereas benevolent loan interest was referred to as usury interest. Ordinary interest was not earned as an extra payment to the lender but as an economic benefit that was obtained from an investment loan, hence, usury became legalized by man.
- In 1361, Bishop Michael Nothburg established the first true charitable credit institutions called montes pietatis in London, a lending institution that provides loans based on collateral and at very low interest rates. In November, 1745, Pope Benedict XIV issued a verdict against usury in a decree called *Vix Peruenit* : On Usury and Other Dishonest Profit. In this decree addressed to the Bishops of Italy, charging of interest on loans as Usury. The Vatican applied this encyclical to the entire Roman Catholic Church in July 1836 during the era of Pope Gregory XVI. Briefly, the decree stated that “the nature of the sin called usury has its proper place and origin in a loan contract. This financial contract between consenting parties demands, by its nature, that one returns to another only as much as he has received. The sin rests on the fact that sometimes the creditor desires more than he has given. Therefore, he contends some gain is owed to him beyond that which he loaned, but any gain which exceeds the amount he gave is illicit and usurious.” The prohibition on usury did not stop only at loan contracts but any “other just contracts...for which it is permissible to receive a moderate amount of interest. Should anyone think like this, he will oppose not only the judgment of the Catholic Church on usury, but also on common human sense and natural reason.” However, the montes pietatis establishments were popular and spread largely by the efforts of the Franciscan Observants throughout Italy and by 1848, the montes pietatis became legislated as municipal establishments with a total capital of 72 million Lire. Whilst these establishments assisted the poor against the commercial interest rates which were exorbitant, it contributed the idea that charging a small interest rate was acceptable and that a small interest rate was not usurious.
- In order to get around the laws prohibiting usury, the European bankers and traders devised a set of three documents called the *contractum trinius*. The *contractum trinius* was signed by a loan applicant and consisted of an investment contract, a sale of profit and an insurance contract. Independently, each of these contracts were permissible by the Church, however, as a set of contracts they equated to an interest bearing loan contract. The lender would invest a sum equal to the financing amount for a year and purchase insurance for the financing from the borrower, and finally sells to the borrower any right to the profit made over a pre-agreed rate of return on the investment. This structure, whilst facilitating the loan and interest payment, provided the lender with protection against default and provided the borrower with the protection of the law in collecting the ‘insurance premiums’. This practice became so popular among bankers and merchants that the Church lost its effectiveness in enforcing the anti-usury laws in Europe. Subsequently, led by Henry VIII of England, European countries overturned their bans on usury. By this time, overturning the usury laws was seen to be for the public good in

stimulating economic growth as evidenced by the proposals of Francis Bacon for two types of usury : one with a low rate to ease the common borrower at 5% and the other, floating interest rates by licenced money lenders for commercial transactions. The objectives of such a move were to “preserve borrowing from any general stop or dryness; ...ease infinite borrowers in the country; ... raise the price of land; this by like reason will encourage and edge industrious and profitable improvements.”[11]

- [1] Stephen Perks, Christianity and Law : An Enquiry into the Influence of Christianity on the Development of English Common Law, 1993.
- [2] Conrad Moehlman, The Christianization of Interest. Church History, Issue 3, 1934.
- [3] John Calvin, Calvin's Ecclesiastical Advice, translated by Mary Beaty and Benjamin Farley, Calvinism Today Volume III, No. 1, January 1993.
- [4] Nehemiah 5:7 – ... Ye exact usury...and I set a great assembly against them.
- [5] Exodus 22:25 – If thou lend money to my people that is poor by thee, thou shalt not to him as an usurer, neither shalt thou lay upon him usury.
- [6] Deuteronomy 23:19 – Thou shalt not lend to thy brother money to usury, nor corn, nor any other thing.
- [7] Deuteronomy 15 : 1-6 – At the end of every 7th year you shall grant a release of debts, and this is the form of the release : Every creditor who has lent anything to his neighbour shall release it; He shall not require it of his neighbour and his brother, because it is called the Lord's release; Of a foreigner, you may require it; but you shall give up your claim to what is owed by your brother, except where there may be no poor among you; ... to observe with care all these commandments which I command you today; ... you shall lent to many nations, but you shall not borrow.
- [8] Proverbs 22:7 – The rich rules over the poor, and the borrower is servant to the lender; He who sows inequity will reap sorrow.
- [9] Natural law is defined as a law that is discovered by man in nature, a man-centred law as opposed to God-centred law by Divine revelation.
- [10] Calvin's letter to Oekolampadius.
- [11] Francis Bacon : Of Usury.