CHAPTER - II

LITERATURE REVIEW & SOME BASIC ISSUES
2.1 General Review: Islamic Banking Concept

2.1.1 Riba and Reasons for its Prohibition

Elimination of interest or *riba* is the core concept of Islamic financial system. It goes without saying that the *Qur'an* has unambiguously and in the most stringent term prohibited *riba*. *Sunnah* further clarifies the concept and the scope of *riba* and its prohibition by its application to barter to barter and exchange of money for money. Despite some controversy in application, the core idea was held unanimously throughout Islamic history.¹ But during the early and mid twentieth century, there started appearing divergent opinions concerning definition of *riba* particularly with discussion on bank interest. The first opinion held by the majority of the scholars was that all forms of fixed return on lending or any excess over it, irrespective of its amount or percentage, would be considered to be *riba* and therefore prohibited. They argued, since interest, whether exorbitant or reasonable, was an addition to the capital borrowed, it was thus, a *riba* and therefore did not comply with the crystal clear teachings of *Qur'an* and *Sunnah* in this regard. Thus they defined *riba* or interest, as any predetermined fixed return for the use of money². It was believed irrelevant whether the *riba* relates to loan for consumption or productive purposes, whether the loans are personal or commercial, whether the borrower is government, a private individuals or a company and whether the rate of interest is high or low.³

Another opinion emerged on the issue in question was that it was only usury (the exorbitant rate), which happened to be exploitative, thus prohibited. They argued that since bank interest being a profit, earned on its operation, could not be regarded as *riba*. The bank interest is different as it does not go against the very norms of

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justice, so there is no moral case against it. They considered interest to be prohibited only when it would seem to be exorbitantly high and exploitative. Therefore, the normal interest cannot be regarded as riba as it is paid by rich banks to ordinary people in contrast to the case prevalent in old Arabia i.e. excess amount paid to rich moneylender by poor people. Further, they were of the opinion that interest as a cost payment should be permitted when they are used;

- By the government to induce savings to finance trade.
- As a fine or punishment for debtors who have not fulfilled their obligations willfully and
- For loans made to finance productive investment.  

It was also argued that in an inflationary economy lender would be exploited due to fall in the future value of his money and since Shari’ah had not permitted exploitation therefore at least to charge extra to compensate (i.e. compensatory) could not be regarded as prohibited. Another argument on the same line was that, since Islam, being the religion of all people and all times to come, could not deprive its people of enjoying banking facilities or make its masses isolating from the benefit of such a large indispensable sector, this argument was based on the perceived notion that banking without interest is not possible at all.  

There was a third but small group who firmly held that Muslims should have no deal with contemporary interest based banking system as it is principally based on riba. As a result of disregarding this system, the necessities arise can be met through some other alternatives. Bait-al Mal (public treasury) like institutions can also offer some of the basic services which are provided by these banks like saving deposit, current deposit and vault facilitation etc. They argued that the bank interest is against

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the very basic objectives of the Shari'ah. Hence it is imperative for Muslims to completely disregard such anti-Islamic system

Anyway, three main reasons for Islamic prohibition of *riba* as mentioned by Cummings *et al* are as following;

- Interest or usury reinforces the tendency of wealth accumulation in the hands of few.
- Islam does not allow gain from financial activity unless the beneficiary is also subject to risk.
- Islam regards the accumulation of wealth through interest as selfish.  

Siddiqi singles out five reasons inferring from the Qur'anic texts. The main economic reasons given for the prohibition of *riba* were that it would hamper investment and employment and be always exploitative and bring instability to the economy. Some other reasons put forward by Islamic economists can be summarized as follows.

1) Transaction based on interest violates the equity aspect of economic organization. The borrower is obliged to pay a pre-determined interest on the sum even though he may have incurred a loss. A fixed charge on capital is unjust since the results of productive enterprise in which capital is invested are uncertain.

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

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7 They are: (1) Riba corrupt society (2) It implies improper appropriation of other people’s property. (3) Its ultimate effect is negative growth (4) It demeans and diminishes human personality. (5) It is unjust.


A system based on profit sharing is more stable than a system based on fixed charge for capital since the cost of capital in a sharing system automatically adjust itself to variations in productivity under changing business conditions. A shock to asset position is automatically absorbed on the liability side.

3) The interest system dampens investment activities because it adds to the cost of investment. Allocation based on profit sharing pays more attention to investment profitability, while allocation based on interest pays more attention to credit worthiness.

4) The interest-based system is security-oriented rather than growth oriented.

5) The interest-based system discourages innovation, particularly on the part of small-scale enterprises.

6) Under the interest based system banks are only interested in recovering their capital along with interest.

7) Under profit sharing system it is the real sector of the economy which determines the rate of return unlike in the financial sector which is based on interest. This system (PLS) puts a check on the supply of money and controls inflation.

8) Risk sharing system will bring more innovation in the economy and encouraged new entrepreneurs to venture into the market.

Abdul Mannan in his book *Islamic Economics: Theory and Practice*, sums up the Islamic point of view on interest in these words “Islam prohibits interest because interest has nothing to do in influencing the volume of savings, because it makes depression chronic, because it aggravates unemployment problem and, finally because it encourages unequal distribution of wealth”.

The issue of *riba* and interest, however, kept haunting time and again in various Muslim countries. However, the matter was finally set-aside during the

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Islamic Conference held in Jeddah in 1973. On the basis of this the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC), in the year 1985, adopted a universal and comprehensive definition of *riba* in these words, “any increase or profit on a loan which has matured, in return for an extension of the maturity date, in case the borrower is unable to pay, and any increase or profit on the loan at the inception of the loan agreement, are both form of usury (*riba*), which is prohibited under the Shari'ah”.¹¹

There is now general consensus among Muslim religious scholars and economists that there is no difference between usury and interest.¹² At least four characteristics define its prohibition.¹³

1. It is fixed *ex ante*.
2. It is tied to the time period and the amount of the principal.
3. Its' payment is guaranteed by the borrower regardless of the out come of the transaction for which the money was borrowed.
4. The state apparatus sanctions and enforces its collection.

To conclude, during the modern times which dominate interest based banking system, having driven by the viability of the contemporary banking system, controversy has aroused about the bank interest as to whether it is the same *riba* prohibited in Qur'an or not. The overwhelming majority regard it as *riba*, whereas few ones see it is not. They feel the need for having a fresh look at the law of *riba* with a view to finding a way out regarding the legitimacy of bank interest. In the words of Siddiqi, “The principle that the excess charged over the principal in the case of a loan is *riba* beyond doubt and thus, the bank interest is *riba*. Those trying to

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¹² For detailed exposition on the issue of *riba* and bank interest, see, Siddiqi, M.N. (2004), ‘Riba, Bank Interest and the Rationale of its Prohibition’, esp. chapter 2 entitled ‘Prohibition of Interest’ op. cit. pp. 35-63. It is the one of the latest works on the subject that comprehensively deals with the issue in question.

legitimize bank interest by arguing that it is different failed to prove their case. The Muslims in general, did not accept the idea even while dealing with banks out of necessity or for the sake of convenience. A section of them kept away from banks and tried to develop alternatives to help the community survive. These efforts got a fillip from the Muslim countries coming out of foreign rule one after another between 1945 (Indonesia) and 1964 (Algeria). It was no accident that the same pried saw the ad vent of the theory of interest-free banking and some modest beginning in its practice. Simultaneously we find a a number of institutions devoted to Islamic research reaffirming that bank interest was covered by the prohibition of riba.\textsuperscript{14}

2.1.2 The Rationale of Islamic Banking

The rationale of Islamic banking revolves around two basic questions. Firstly, is the financial intermediation necessary? And secondly, is the financial intermediation possible without interest?

As for the first question, Islamic economists are convinced that financial intermediation is necessary. In the words of professor Sidiqi, “we suggest that financial intermediation is a necessity (darurah) in the full technical sense of the Shariah term. If an Islamic society does not have financial intermediaries it will either become weak and wither away or people alien to that society will take over the function of financial intermediation with dire consequences for its financial as well as monetary system”.\textsuperscript{15}

Some other reasons mentioned by Islamic economists, for the necessity of financial intermediation, are the same as put forward by the conventional economists. For example financial intermediation enhances the efficiency of the saving and investment process by reducing transaction costs and eliminating the mismatches inherent in the needs of surplus and deficit units of economy. Besides this agency

\textsuperscript{14} Sidiqi, M.N. (2004), ‘Riba, Bank Interest and the Rationale of its Prohibition’ op. cit., p.56
problem arising due to asymmetric information is also reduced by financial intermediation. Munawar Iqbal et al stress that “Islamic financial intermediation endeavors to replace interest by other modes and instruments both for mobilizing savings and putting those savings into productive use. The functions that the banks perform are important whether the economy concerned is secular or Islamic. People need banking services. Now, since the banking services are needed but interest is prohibited, Islamic economies have to find alternative ways of performing various banking functions. This challenge provides the rationale of Islamic banking.”

As for the second issue i.e. is financial intermediation possible without interest or fixed payment basis. Islamic economists reply in affirmative. They are of the opinion that it is not only possible but more desirable and efficient in many ways. As noted in the Pakistan Shariat Court judgment on riba, “The writers on Islamic economics are unanimous on the point that banking system can discharge all its present day functions even without the element of interest. These thinkers also agree that the reorganizing banks on Islamic lines should be done on the basis of Shirkah and Mudarabah.”

Contemporary commercial banking activities are based on creditor and debtor relationship where banks only play intermediary roles between the savers (depositors) and the investors (borrower). It charges higher interest from the borrower and pays lower to the depositor the balance (spread) is kept by the bank to meet its own costs and pay for its shareholders. This kind of creditor-debtor relationship is not permissible under Islamic law framework. The other Islamic

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16 Agency problems arise when one party serves as an agent for another. The two major types of problems are that of moral hazard and adverse selection. Moral hazard arises due to hidden action when one party has the incentive to shift the risk onto another uninformed party. Adverse selection is due to hidden information, when one party has access to more information. Agency problem also occurs due to a conflict arising out of selfishness. Weak regulatory and legal systems worsen this problem. (For its analysis, see, Nadim ul Haq, ‘Developing of Financial markets in Developing Economies’, Address at the Financial Reform Conference, Trans Asia Hotel, Colombo, Sri Lanka, March 18, 2002).


18 For more details please see the above section, ‘the idea of Islamic banking’.

19 Pakistan Federal Shariat Court Judgment on Interest (Riba), Islamic Economics Translation Series No. 8, IDB/IRTI, Jeddah, 1995, p. 74.
principle in matter of Islamic financial transaction is that there should be no reward without bearing the risk which is applicable both to labour and capital, i.e. no payment is allowed to labor unless it is applied to work, no reward for capital should be allowed unless is exposed to business risks. Financial intermediation in an Islamic framework is based on these two principles.\(^{20}\)

Shaikh Mahmud Ahmad combed through nearly all theories of interest developed since the time of Adam Smith to show that there had been no satisfactory explanation of existence of a fixed and predetermined rate of return to financial assets. He further went on, analyzing the writings of economists such as Keynes, Bohm Bowerk, Cassels, and Samuelson, to argue that an objective assessment of these writings would lead one to believe 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. Mohsin S. Khan, in his article 'Islamic Interest-Free Banking: A Theoretical Analysis,' remarks\(^ {21}\) that the abolition of interest-based transactions is not a subject alien to even western economic thought. Several western writers including Fisher, I., \textit{100 \% Money}, 1945, Simons, H., \textit{Economic Policy for a Free Society}, (1948) and Friedman, M., 'The Monetary Theory and Policy of Henry Simons,' in Friedman, M., (ed.), \textit{The Optimum Quantity of Money and Other Essays}, (1969), among others, have argued that the current (one-sided liability) interest-based financial system is fundamentally unstable.\(^ {22}\) In Simon’s view the basic flaw in the traditional system is that, as a crisis developed and earnings fell, banks would seek to contract loans to

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\(^{22}\) Monetary economists insist that a zero nominal interest rate is a necessary condition for optimal allocation of resources. They argue that after switching from metallic to fiat money, adding one marginal unit of real balance costs no real resources to the community. Therefore, imposing a positive price on the use of money would lead traders to economize on the use of money, in their pursuit to minimize their transaction costs. They would therefore use some real resources instead of money. However, when the rate of interest is zero traders will have no incentive to substitute real resources for money. More real resources can therefore be directed to consumption and investment.
increase reserves. Each bank could do so, however, only at the expense of other banks.\textsuperscript{23}

Frequent economic and banking crises especially banking failures in the United States during 1930s and in 1980s only increased the consternation and led to belief that there is something fundamentally wrong with the modern banking sector. Many experts held that fractional reserve banking system was inherently unstable and therefore should be replaced with two separate financial institutions.\textsuperscript{24} Such arguments for a system based on profit & loss concept have also been made in the wake of bank failures in other countries.

1. Deposit Banks with 100\% reserves.
2. Investment Trust, to perform the lending functions.

Abbas Mirakhor, associated with the International Monetary Fund (IMF), in his article \textit{Progress and Challenges of Islamic Banking} speaks about the conventional economists who during late 1950s tried to answer two fundamental questions regarding banking system that had not been addressed (1) Why did banks develop and (2) why were all their operations based on fixed fee contracts? Mirakhor says that these questions were unfortunately, albeit indirectly, relevant to the theory of Islamic banking\textsuperscript{25}.

The explanation given for the existence of banks was "necessity of an intermediate between the preference of lenders for short term liquid assets and the preference of borrowers for long term illiquid liabilities. Another was that bank being operating at high volume enjoy benefits from economies of scale. According to Mirakhor, the second question why do banks operate at fixed fee basis has been much harder to explain, not only this but many other related questions regarding


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interest rate ceilings on bank liabilities and other controls and regulations like reserve requirements, control on assets and entry and deposit insurance needed answers.

By the mid 1980, economic and financial theory had shown that there was disadvantages in the fixed pay off contracts that dominated interest based banking because: (Following conclusions were drawn concerning fixed pay off contracts.)

- These contracts create inefficient default or non-performing assets.
- In the presence of asymmetric information, debt contracts suffer from adverse selection effects and moral hazard effects.
- Reserve requirements gave unnecessary extra liquidity to the regulatory authority, which in many cases aggravated the fiscal imbalance.
- Deposit insurance reduced the depositor’s willingness to watch the functions of these banks. All the above had an adverse effect on the functioning of these banks especially during crises.
- Fixed fee contracts create a fundamental conflict between the interest of the borrowers and the lenders.
- Socially desirable sectors with low profitability would not get finance. More over new entrepreneurs with good projects may not get finance in absence of security required.
- It has been observed that during the crises, to attract more deposit these institutions have increased their deposit rates while their earning reduced and thus they trapped into the crises.

Having examined the resulting effects of fixed pay off contracts, the reasons for a system free from such undesirable effects were put forth as:

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26 Ibid., p. 6.
• On the contrary, Islamic banks are those, which are based on equity finance and are more immune to such crises. The real value of their assets and liabilities would be equal to all points to time. There will be a close relationship between investment and deposit fields.

• Return on liability is the direct function of the return to assets.

• Adjustment to shock that results in banking crises and disruption of the payment mechanism is more rapid than in conventional system.

Siddiqi in his paper on ‘Rationale of Islamic Banking’ first made a critique on debt finance and the function of contemporary banking system on the basis of fixed interest payment and pointed out the resultant unhealthy repercussions on the economy and society as a whole. He dealt in detail with undesirable effects of modern banking system under the heads:

In view of adverse outcome emerged from the practices of modern banking system and thus its incapability of ensuring the best interest of the people, he proposed, as an alternative, the concept of interest free-banking system primarily based on profit sharing model.28 He put forward many advantages and benefits of profit-sharing mode like allocative efficiency, stability in the value of Money, increase in the volume of investment, justice and Equity in distribution, curbing speculation, mobilization of savings and profitability of investment etc.

2.1.3 The Theoretical Preparation for Islamic Banking

Theoretical development of Islamic banking can broadly be divided into following subheads:

2.1.3.1 Early Writings on Islamic Banking

These are several writings of the classical Islamic economists who are considered to be the founding pillars of the modern Islamic banking. Their ideas were

taken up and followed by others in the later years for the developments of the Islamic banking. Owing to very fast developments, in recent years, the works of these writers may not be looked as very clear in perception but they obviously are considered to be the architects of Islamic banking mainly for conception and proposition of their ideas. An analysis of the literature on the subject reveals that during the first half of the 20th century, almost half of the total literature available in the world was in the Urdu language the rests being either in English or in Arabic language.29

Some Muslim intellectuals and Ulama like, Maulan Syed Abul Ala Maudoodi, Imam Muhammad Baqir al-Sadr, Anwar Iqbal Qureshi, Mohammad Nejatullah Sidiqi, Muhammad Uzair and Ahmad al-Najjar are amongst the pioneers of the Islamic banking movement.30


practical effort in the field of Islamic banking; his several other writings A Suggestion For an Interest Free Islamic Monetary Fund (1955), and Interest Free Lending Banks (1962) also belong to the above category.

Mohammad Uzair’s An Outline of Interest less Banking (1955) has the distinction of being the first published work exclusively devoted to the subject of Islamic banking. His work Factors Contributing to the Success of Interest Free Banks (1958) is also worth mentioning.

Muhammad Nejatullah Siddiqi’s A Model of Interest Free Banking and Ghair Sudi Bankari (Banking Without Interest, 1969) are considered few of the important contributions to Islamic banking in many respects. In his book Professor Siddiqi has dealt with bank model, creation and control of credit, consumer and government finance, and provision for short-term interest free loans to business. He has also introduced certain financial papers to replace bonds and securities. Some other mentionable works are summed up in the following table:

Table No.1

Some Early Writings on Islamic Economics and Banking

<table>
<thead>
<tr>
<th>Writer</th>
<th>Title of the Book</th>
<th>Year of Publication</th>
<th>Language</th>
</tr>
</thead>
<tbody>
<tr>
<td>Naiem Siddiqui,</td>
<td>Islami Usool Par Banking</td>
<td>1948</td>
<td>Urdu</td>
</tr>
<tr>
<td>Maulana Abul A’la Mawdudi</td>
<td>Sood</td>
<td>1951</td>
<td>Urdu</td>
</tr>
<tr>
<td>Shaikh Ahmad Irshad</td>
<td>Bila Sood Bankari</td>
<td>1964</td>
<td>Urdu</td>
</tr>
<tr>
<td>Mohammad Akram</td>
<td>Islami Maishat Men Bank aur Bachaten</td>
<td>1965</td>
<td>Urdu</td>
</tr>
<tr>
<td>Author</td>
<td>Title</td>
<td>Year</td>
<td>Language</td>
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<tr>
<td>S. Hasanuzzaman</td>
<td><em>Interest free consumption Loans and Consumer Behaviour</em></td>
<td>1964</td>
<td>English</td>
</tr>
<tr>
<td>R. K. Ready</td>
<td><em>Egyptian Municipal Savings Banks Project</em></td>
<td>1967</td>
<td>English</td>
</tr>
<tr>
<td>Shaikh Mahmood Ahmad</td>
<td><em>Banking in Islam</em></td>
<td>1969</td>
<td>English</td>
</tr>
<tr>
<td>Muslehuddin Ahmad</td>
<td><em>Banking and Islamic Law</em></td>
<td>1974</td>
<td>English</td>
</tr>
<tr>
<td>Shalibi Ahmad</td>
<td><em>Islamic Bank</em></td>
<td>1969</td>
<td>Arabic</td>
</tr>
<tr>
<td>Mohammad Issa</td>
<td><em>Banks Without Interest</em></td>
<td>1970</td>
<td>Arabic</td>
</tr>
<tr>
<td>Baryun Nuri Abdussalam</td>
<td><em>The Shape of The Banking System in Islamic Economy</em></td>
<td>1972</td>
<td>Arabic</td>
</tr>
</tbody>
</table>


It may be noted that the majority of the second-generation writers on Islamic banking unlike first generation that mainly consisted of Ulama belonged to professional economists.

The period from 1930 to 1974 is characterized by theoretical writings on Islamic economics and banking, which can undoubtedly be described as the foundation period of Islamic banking. Most important writings of the period include Muhammad Uzair (1953), Mohammad Nejatullah Siddiqi 1961, 1969, Abdullah Ali Arabi, 1967, Baqir-al- Sadr 1961, 1974 and Ahmad-al-Najjar, 1971.  

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2.1.3.2 Seminars, Conferences, Committees and Institutions

Seminars and conferences have played a vital role in the concept, development and practice of the Islamic banking. In this regard Finance Minister’s conference in Karachi in 1970 and Egyptian study of 1972 are path breaking in many respects. However, it was the first International Conference on Islamic Economics held at Makkah 1976 that served as a catalyst at an international level and led to an exponential growth of literature on the subject. Islamic Fiqh Academy Seminar at Jeddah in the year 1985 is important in respect that a common definition of Riba was the outcome of this seminar i.e. a consensus on the definition of Riba that ended all previous speculation and controversies.

Islamic Finance Information Programme launched in Dec. 1995 has become a regular feature of Harvard University Forum. The seventh of such Islamic Finance Information Programme (HIFIP) has completed in April 2006. Proceedings of these programmes are published and available in the market. Institute of Islamic Banking and Insurance, London (1991) and Islamic Research & Training Institute (IRTI) of IDB Jeddah has made a significant contribution to the field of Islamic finance through research, publications, lectures, seminars, workshops and training courses.

During the last decade a number of institutions, bodies and centers were set up and scores of seminars, conferences on national and international levels were held on various aspects of Islamic banking & finance which had played important role in the development of the discipline and have become a regular feature since 1970s and kept the tempo of Islamic banking high.

33 It can also be found at the website of Islamic Finance Project which is the continuation of HIFIP and the part of the Islamic Legal Studies Program (ILSP) at Harvard Law School. It aims to study the field of Islamic finance from the legal and shari’a points of view by analyzing contemporary scholarship, inducing collaboration among scholars within and outside the Muslim world, and increasing the interaction between theory and practice in Islamic finance. http://ifptest.law.harvard.edu/ifphtml/
2.1.3.3 Compilation of Previous Works

Proper recording and compilation of previous works is important in many respects. It is an indicator of the direction and development of the subject. Few most important works in this field includes M. Akram’s, *Annotated Bibliography of Contemporary Economic thought in Islam and Glossary of Islamic Terms in Islam* prepared in 1973. It has compiled the work done in the field in English and Urdu languages. This bibliography was first published in 1983; another important work published in 1974 is done by Atiyah Jamal al- Din “Dalil al Bahith fil Iqtisad al-Islami” Arabic (A Guide to Researcher in Islamic Economics). One of the most popular work under this category was done by Muhammad Nejatullah Siddiqi34 “A Survey of Contemporary Literature on Islamic Economics” it was prepared in 1974 and published in 1980. Another important work by Muhammad Nejatullah Siddiqi, published in 1982 is *Recent Works on History of Economic Thought in Islam: A Survey*, this paper surveys the recent writings in Arabic, English and Urdu on the economic thinking of twenty seven eminent Islamic thinkers of the past from Imam Abu Hanifa to Allama Iqbal. M. A. Mannan’s *Abstracts of Researches in Islamic Economics*, 1984, is the listing of the works carried out by International Centre for Research in Islamic Economics (ICRIE) either independently or in collaboration with others. Nazim Ali and Nasim Ali (1994) have compiled the work *Information Sources on Islamic Banking and Economics 1980-1990*. This work covers the writings during the period of 1980 to 1990. ‘A Bibliography of Islamic Economics’ was also published by IRTI in 1993. One of the important additions into this line of work is *Islamic Economics & Finance A Bibliography* by Javed Ahmad Khan, published by Mansell, U.K. in 1995. Since then many have updated and extended such works with the latest literature review. This job is being regularly carried out by various noted journals and research institutions. *Muslim World Book Review* is one of

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such academic magazines which regularly covers recent works on the subject of Islamic Economics, Finance & Banking.

2.1.3.4 Research Paper and Magazines

Various magazines and publications have become a regular feature on the subject of Islamic economics, finance and banking. Occasional papers, seminar proceedings published by various institutions like Islamic Research and Training Institute, (IRTI), Islamic Development Bank (IDB), The Islamic Foundation, UK, Center for Research in Islamic Economics, (CRIE) have played important role in disseminating the information on the discipline. Islamic Finance Project (IFP) of Harvard law school has become one of the important annual features for Islamic finance during the last few years. Some of the important magazines and journals on the subjects are; Review of Islamic Economics, UK, Islamic Economic Studies, Jeddah, King Abdul Aziz University Journal of Islamic Economics, Jeddah, American Journal of Islamic Finance, USA, New Horizon, Institute of Islamic Banking and Insurance, UK, Journal of Islamic Economics, Malaysia, Thoughts on Economics, Dhaka, Bangladesh, Journal of Islamic Banking and Finance, Karachi, International Journal of Islamic Financial Services (IIFS) of IBF Net (now IBF review), Islamic Banking and Finance, Brighton, Islamic Business & Finance of CPI Financial, Dubai and Islamic Finance Today, Sri Lanka etc.

2.1.3.5 Research Institutions and Professional Associations

Several organizations and research institutes have played important role in the development of concept and practices of Islamic banking.35 One of the main institutions supporting Islamic Financial Service Industry (IFSI) has been the Islamic Development Bank (IDB) that initiated the establishment of the first infrastructure

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35 Islamic Fiqh Academy, Jeddah (1981), The Association of Muslim Social Scientist, U.S.A. (1972); the Islamic Foundation, Leicester, U.K. (1973); Islamic Economics Research Bureau, Dhaka, Bangladesh (1976); the Center For Research in Islamic Economics, the King Abdul Aziz University, Jeddah (1977); the International Institute of Islamic Thought, Herndon, Virginia, U.S.A. (1981); the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (1983); the International Institute of Islamic Economics, Islamabad (1983); the International Association for Islamic Economics (1984).
institution the Accounting and Auditing Association for Islamic Financial Institutions (AAOIFI), followed by a group of infrastructure institutions each of them is specialized in a specific field serving IFSI. This group of institutions comprises of the General Council for Islamic Banks and Financial Institutions (CIBAFI), the International Islamic Financial Market (IIFM), the Islamic Financial Services Board (IFSB), the International Islamic Rating Agency (IIRA) etc. Few of such organizations devoted specifically to the cause of Islamic banking practices are mentioned blow:

(i) *The International Association of Islamic Banks (IAIB)*: established in 1977 by the Islamic Development Bank. This association is playing an important role in the meeting of central banks and monetary agencies of the Islamic countries as well as the meetings of the specialized bodies of the OIC in the field of banking and insurance. The association aims to strengthen ties between Islamic financial institutions, fostering cooperation, coordinating their activities and monitoring their operations to insure that they conform to the *Shari‘ah*. It provides technical assistance and expertise to the people wishing to establish Islamic banks. It also represents the common interests of Islamic banks at national and the international level. Now CBAFI has taken its form to involve specifically in few of these activities.

(ii) *Accounting and Auditing Association for Islamic Financial Institutions (AAOIFI)*: is a self-regulated organization founded by Islamic banks worldwide in 1991. It is striving to regularize accounting standard across Islamic banking. It has established sixteen accounting standards, four on accounting, and three on governance. It has also started issuing *Shari‘ah* standards.

(iii) *Institute of Islamic Banking and Insurance (IIBI)*: Established in 1993 to render a service to Islamic banking & insurance. The institute offers a diploma course

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36 It has now been merged and renamed as The General Council for Islamic banks and Financial institution.
in Islamic banking and insurance and publishes a monthly called *New Horizon*. Its main objectives are as follows;

1) Promotion of knowledge of Islamic banking and insurance through conferences, seminars, lectures and publications.

2) Education of personnel in Islamic banking & insurance.

3) Assistance and advice on all aspects of Islamic banking & insurance.

4) Development of Islamic financial institutions.

5) Study and research on issues and problems in the field of Islamic banking & insurance.

(iv) Islamic Financial Services Board (IFSB): A Malaysia based organization is recently established by the Islamic Development Bank (IDB), Accounting and Auditing Association for Islamic Financial Institutions (AAOIFI) with the active collaboration of the International Monetary Fund (IMF). According to IMF sources the IFSB will serve as an association of institutions that have responsibility for the regulation and supervision of the Islamic financial services industry and will:

I. Set and disseminate standard and core principles as well as adapt existing international standards for supervision and regulation, consistent with the *Shariah*.

II. Liaise and cooperate with other standard setters in the areas of monetary and financial stability.

III. Promote good practices in risk management in the industry through research, training and technical assistance.\(^{37}\)

### 2.2 Specific Review

#### 2.2.1 Islamic Modes of Finance

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\(^{37}\) *International Monetary Fund*, News Brief, No. 02/41, May 1, 2002.
Bahgat Khalil El Sharif (1990) in his dissertation highlights in detail, conditions of mudarabah under the major doctrines of Islamic Shariah: conditions relating to the parties and capital; sharing of risks and profits, and other important features of mudarabah. It also undertakes a detailed examination of Murabahah and its features in the Islamic legal framework. His study investigates the current practices of Islamic banks relating to mudarabah and murabahah and their degree of conformity to the classical Islamic legal framework.

Prof Siddiqi (1992) in his writing focuses on the different perceptions about the likely impact of Islamic banks' operations on money supply. Since investment accounts with the Islamic banks carry some withdrawal facility, new money is created when the funds in these accounts go to entrepreneurs on profit-sharing or Murabahah basis. The paper argues that as compared to the conventional banks money creation by Islamic banks is more closely associated with the creation of additional wealth in the real sector. The resulting expansion in money supply will be smaller compared to that resulting from conventional banks' lending out of their time and saving deposits. The Islamic banks should, therefore, be subjected to a reserve ratio smaller than that applied by the central bank to the conventional banks.

Fahim Khan (1992) provides in his paper a comparison to the economic features of different modes of Islamic financing and discusses the effect and benefit from the application of these modes. The permissibility and availability of a variety of modes of financing with different economic implications has been elaborated.

38 El Sharif, Bahgat Khalil Law and Practice of Profit-Sharing in Islamic Banking with Particular Reference to Mudarabah and Murabahah.
40 Khan, M. Fahim, ‘Comparative Economics of Some Islamic Financing Techniques’ IRTI/IDB
Ausaf Ahmad (1993)\(^{41}\) in his work analyses Islamic financing techniques used by various Islamic banks and explores differences, if any, in the use of these financing techniques by these banks.

Tarek S. Zaher & M. Kabir Hassan (2001)\(^{42}\), in their paper though, provides a comprehensive comparative review of the literature on the Islamic financial system but specifically deals with the basic features of the Islamic finance and banking and Islamic financial instruments in order to compare them to existing Western financial instruments and discuss the legal problems that investors in these instruments may encounter. The paper also gives a preliminary empirical assessment of the performance of Islamic banking and finance, and highlights the regulations, challenges and problems in the Islamic banking market.

Iqbal and Llewellyn (2002)\(^{43}\) argued that the modes of financing used by Islamic banks are, however, unique for two reasons. First, debts associated with financing by way of mark-up modes results from real commodity sale/purchase operations, rather than the exchange of money for interest-bearing debt. Second the introduction into banking of modes that depend on profit sharing is an innovation that brings important advantages.

However, large number of works available discusses Fiqhi and economic issues concerning Islamic modes of finance and is mostly confined to critical comment on the observed practice of Islamic banks. Various literature survey the historical evolution of Islamic method of Financing.

### 2.2.2 Murabahah:

\(^{41}\) Ahmad, Ausaf, 'Contemporary Practices of Islamic Financing Techniques', IRTI/IDB, Jeddah.

\(^{42}\) Zaher, Tarek S. & M. Kabir Hassan, 'A Comparative Literature Survey of Islamic Finance and Banking', IRTI/IDB.

• Sami Hasan Hamoud (1976)\textsuperscript{44} in his Ph. D. thesis first introduced the concept of “Murabahah lil 'Amir bil Shira” in contemporary Islamic finance, based on a fatwa by Sheikh Faraj al-Sanhuri. Banking finance based on the classical Mudarabah principle has been challenged by Hamoud & others. He pointed out some limitations of classical Mudarabah principle in its application to the modern needs of financing and suggested a proposal as other alternatives to them. In his work, he invited attention to the cases where Mudarabah is incapable to provide financing e.g. consumer’s goods, (durable or non durables), goods supplied to government and industry etc. He was in search of an Islamically acceptable financial instrument capable of competing with conventional consumer-finance product. Thus since the publication of Hamoud (1982) Murabahah emerged as a principle distinct from sharing one (PLSP) and became the backbone of contemporary Islamic Finance. Islamic banks welcomed this new addition from fiqh that allowed them to replace a significant part of their practice of high risk amanah financing such as Mudarabah & Musharakah. Sami developed this concept on the basis of Imam Shafi’i’s concept of al-Murabahah.

• Dr. Abdul Hameed al- Ba’ali\textsuperscript{45} in his book dilates upon Murabahah contract from legal (fiqhi) perspective covering the opinions of all four famous schools of Classical Jurisprudence viz. Hanafi, Maliki, Shafi’I and Hanbali including Zahiri. The work has a good discourse on different aspects and issues of Murabahah with all possible fiqhi discussion. While concluding the debate, the author does the comparative analysis among different opinions and thereby establishes a favouring opinion. There is also juristic analysis on contemporary issues of Murabahah.

\textsuperscript{44} Hamoud Sami Hasan (1396 AH/ 1976), ‘Tatweer al-a’amat al-Masrifiyah bima yuttafiqu wa’t Sahariyah al-Islamiyah’, Cairo, 1st ed. (a Ph.D. dissertation)

\textsuperscript{45} Al- Ba’ali, Abdul Hameed (n.d.) ‘Fiqh al-Murabahah fi al-Tatbeeqat al-Iqtisad al-Ma’asir’, Cairo, Maktabah al-Salam al-Alamiyah

33
Dr. Yusuf al-Qaradawi (1984) in his writing, has successfully dealt with the critique & arguments put forth against contemporary Murabahah and tried to remove the objections with legal evidences deduced from Qur’anic verses, Sunnah & other sources of shariah including logical reasoning. He first presented the opponent views and their arguments then did the critical appraisal of their viewpoints and pointed out the underlying weakness in their standpoint and thereafter clarified the confusion that led to misconception related to contemporary Murabahah. He is very clear in his argument. His work discusses the nature and form of Murabahah contract and its peculiarities and elaborately deals with one of the most important issues of contemporary Murabahah i.e. whether the promise is binding or non-binding on the part of promisor (client). Dr. Qaradawi argues in favour of binding nature of promise by putting forth the arguments of both earlier scholars and later ones. Dr. Rafiq al-Misri had strong reservation in this behalf and hence put a rebuttal to binding Murabahah and argued for non-binding Murabahah. He critically examined the arguments and points put forth by Yusuf al-Qaradawi. Qaradawi then clarified more the issue in question and tried to spell out the picture on the matter referring to the objections of al-Misri.

Ahmad Ali Abdullah (1987) in his work has tried to touch all concerning issues of Murabahah and its contemporary application & practices and analyse them in fiqhi perspective taking into account the opinions of various schools of jurisprudence including Zahiri & Shi’ites. The author also critically analyses the legal opinions and argues for convincing one. The second chapter of the book is very significant in the sense that it deals at length with contemporary Murabahah, its concerns and important aspects. The various misconceptions and objections raised against Murabahah have been dealt in the light of legal opinions of classical fiqhah.

Jamal Attieh (1990) in his work highlights legal problems that arise in implementing Murabahah (mark-up) contract as a financing tool that is widely used by Islamic banks. He argues that major problem is the question of bank ownership of the financed commodity. This ownership is required by shari'ah but prohibited by banking laws in many countries. Exempting Islamic banks from such laws-as has often been the case-and referring them to fiqh leaves important legal gaps, because fiqh encompasses several and occasionally opposite views. He also discusses a bank's rights and obligations in case of traditional letter of credit as compared to Murabahah and concludes with suggested solutions to the problems raised. Some suggestions require specific changes in laws, while others may be adopted by individual banks.

Dr. Attieh Fayyaz (1999) deals rather much in detail with the subject of Murabahah. He has elaborately discussed ordinary and contemporary Murabahah with pros and cons in the light of Islamic law (fiqh). His work covers various important issues related to Murabahah like promise to purchase & its bindingness, conditions for validity of the specific form of contemporary Murabahah, expenses in relation to Murabahah, increased price due to deferred payment, rebate on earlier payment, the issue of providing securities and guaranteeing, financial discount in the case of paying installment on time etc. In short, his work provides a full discourse on each aspect of the subject.

Yusuf Talal DeLorenzo (1997) has compiled a useful compendium of legal opinions (fatwa) on the operations of Islamic banks based on the Arabic fatwa having English translation with original Arabic text. Its chapter on Murabahah classifies the questions and answers in terms of contract components, contract

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provisions, and the contract itself and the prohibited cases. In view of Murabahah being prevalent and termed as a suspect contract, this chapter includes about 70 percent of the questions and fatwas of the compendium. However, different and opposing opinions were not presented on the issues in question. If it is so, it would prove to be very useful and valuable in order to appreciate the matter in depth.

- M. Taqi Usmani, (2000)\(^51\) in his work has analysed various important issues of contemporary Murabahah from legal, logical and economic point of view in clear, simple and convincing way. Being a shariah advisor of a number of Islamic Banks with substantial experience of their working, he provides a thoughtful and pertinent analysis on the subject taking cognizance of the realities of present times. For proper understanding the issues, he discusses them in the light of the authoritative texts of Shariah sources and the lessons learnt from Islamic Banking experiment. He has more innovative approach to *ijtihadi* matters without disregarding the traditional juristic opinions but he does not follow the unambitious approach often adopted by Muslim scholars with regard to the prohibition set by *shari'ah* concerning financial matters. He gives the reasons which justify these prohibitions, instead of merely raising them and shielding behind them without providing an explanation. He does not also hesitate to warn where necessary, e.g. he points out that that using Murabahah and Ijarah as modes of financing is not what these two concept were meant for and therefore, when they are applied outside their original purpose, additional requirements must be fulfilled. His work relies substantially on classical Arabic sources with logical interpretation and thus it is one of the best reference on the subject available in English language.

Some booklets, articles and conference paper specific to Murabahah have been written in English and Urdu languages. But to my little knowledge, a comprehensive work in English on the subject from the legal (fiqhi) and economic point of view with empirical evidence as in the case of PLS financing modes has not

be attended so far. There might be some good works of contemporary scholars on the subject but the researcher is not aware of them till date.

There are numerous articles and conference paper dealing specifically issues of contemporary Murabahah financing such as legal aspect, risk default in payment, viability for short, medium & long terms finance, practical aspects, problems & difficulties and controversial issues relating to Murabahah, time value of money in deferred Murabahah etc.

2.3 Fundamentals and Some Basic Issues:

Much of what follows is borrowed from other writings as it is the restatement of the well-known facts.

2.3.1 Islamic Finance and Conventional Finance:

Prohibition of interest has not been the only factor responsible for the development of Islamic banking. Banking is just a part of overall economic system whether conventional or Islamic. Failure of the conventional economic theories to resolve out many contemporary problems like unemployment, inflation, increasing income inequality, along with the falling down of the myth of Philip's curve, and many time conflicting objectives of the conventional economic theories escorted the Muslim thinkers to reconstruct the objective of economics as subject of social science. Chapra, a research advisor at Islamic Research and Training Institute (IRTI), submits that continued deviation of the conventional economics from normative to positive approach resulted in many conflicting objectives like:

A. Harmony between individual preference and social interest
B. Equal distribution of income and wealth.
C. Reflection of the urgency of wants by prices.

52 The recent experiences of stagflation, high rates of unemployment existing simultaneously with high rates of inflation has raised serious doubts about the validity of the Philip’s curve, which postulated a stable tradeoff between inflation and unemployment.

D. Perfect competition

Chapra argues that market forces, not like the presuming conventional economists, may not always be in harmony between the individual preference and the social interest. He cites the case of pollution, which is social cost to the society and any efforts to reduce it would violate the condition of Pareto’s optimality. He also asks why conventional economics does not take into account the social costs resulting from bank of need fulfillment, unemployment, inequitable distribution and economic instability.

Inequality in income and wealth tend to be biased in favor of rich at the cost of poor. This diverts the scarce national resources in favor of production of status symbol, inessential unproductive goods at the cost of socially preferable need fulfilling items. For example Arthur Okun remarked that market tend to award prizes that allow the big winners to feed their pets better then the losers can feed their children.\(^54\)

The reason given by Chapra behind the market failure in his own word is that, “the secularist paradigm has led to an excessive commitment to neutrality between ends, abstinence from value judgments and choice primarily through the market” which is not inconformity with the needs of goal realization.\(^55\)

Contrary to this, Islamic economics is based on a paradigm, which has socio-economic as its primary objective. This objective takes its roots in the belief that human beings are the Vicegerents of the one Allah, who is the creator of the universe and every thing in it. They are brothers unto each other and all resources at their disposal are a trust from Him to be used in a just manner for the well being of all. They are accountable to Him in the hereafter and will be rewarded or punished for how they acquired and used these resources. In Islamic economics the human beings are not considered to be dependent primarily on maximizing wealth and

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consumption, rather it requires a balanced satisfaction of both the material and spiritual needs of the human beings. The fundamental difference between both the economic systems is well represented in their respective banking systems.

An International Monetary Fund study by Iqbal and Mirakhor\textsuperscript{56} has found Islamic banking to be a viable proposition that can result in efficient resource allocation. The study suggests that banks in an Islamic system face fewer solvency and liquidity risks than their conventional counterparts. The multi-purpose and extra-commercial nature of the Islamic banking operation does not seem to pose intractable problems. The abolition of interest makes it imperative for Islamic banks to look for other instruments, which renders operations outside the periphery of commercial banking unavoidable. Such operations may yield economies of scope.

One of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis. It is especially in this sense that Islamic banks can play a catalytic role in stimulating economic development. In many developing countries, of course, development banks are supposed to perform this function. Islamic banks are expected to be more enterprising than their conventional counterparts. According to Abbas Mirakhor:

"[An] important function of Islamic finance that is seldom noted ... is the ability of Islamic finance to provide the vehicle for financial and economic empowerment ... to convert dead capital into income generating assets to financially and economically empower the poor ..."\textsuperscript{57}

\textsuperscript{56} Iqbal, Zubair and Mirakhor, Abbas (1987), Islamic Banking, Occasional Paper 49, International Monetary Fund, Washington D.C.

\textsuperscript{57} Mirakhor, Abbas (2002) Hopes for the Future of Islamic Finance (Lecture at the Institute of Islamic Banking, London)
Development is promoted through various business practices and almsgiving (zakat). Conventional finance typically focuses on profit-maximization within a given regulatory framework, whereas Islamic finance is also guided by these other Islamic principles.

The special characteristics of Islamic finance can provide alternative means to reaching underserved groups such as small, rural, and agricultural producers. Projects that could be turned down by conventional banks due to a lack of collateral, may be financed by Islamic banks on a profit-sharing basis. In this regard, Islamic finance can catalyze economic development and reduce poverty.

Conventional banking is essentially based on the debtor-creditor relationship between the depositors and the bank on the one hand, and between the borrowers and the bank on the other. Interest is considered to be the price of credit, reflecting the opportunity cost of money.58

Islam, on the other hand, considers a loan to be given or taken, free of charge, to meet any contingency. Thus in Islamic Banking, the creditor should not take advantage of the borrower. When money is lent out on the basis of interest, more often it happens that it leads to some kind of injustice. The first Islamic principle underlying such kinds of transactions is that “deal not unjustly, and ye shall not be dealt with unjustly” 59 Hence, commercial banking in an Islamic framework is not based on the debtor-creditor relationship.

The second principle regarding financial transactions in Islam is that there should not be any reward without taking a risk. This principle is applicable to both labor and capital. As no payment is allowed for labor, unless it is applied to work, there is no reward for capital unless it is exposed to business risk.60 Thus, financial intermediation in an Islamic framework has been developed on the basis of the above

59 Al-Qur’an, 2:279
two principles. Consequently financial relationships in Islam have been participatory in nature. Several theorists suggest that commercial banking in an interest-free system should be organized on the principle of profit and loss sharing. The institution of interest is thus replaced by a principle of participation in profit and loss. That means a fixed rate of interest is replaced by a variable rate of return based on real economic activities.\(^{61}\)

Unlike conventional banks which rely on documentary evidence and usually have impersonal, arms-length, passive relationships with the majority of their clients, Islamic banks have more stringent Know-Your-Customer requirements. The reason for this difference is quite commonsensical. Conventional banks rely on a fixed pre-determined return framework and are, therefore less concerned about the character and credibility of their clients. They are often, more pre-occupied with the underlying securities and assets. On the other hand, Islamic banks are engaged in a quasi-partnership profit-loss sharing framework and therefore have to know their clients, their businesses, as well as, their sources and uses of funding in order to satisfy themselves about the authenticity and legitimacy of their counterparties. Thus, they would be in a much better position to detect, prevent and disengage quickly from suspicious transactions compared to conventional banks. In addition to normal audits, Islamic banks have to conduct Shari'ah review of their transactions for ensuring Shari'ah compliance. This review will catch any funds mobilized or used for haram (prohibited) activities.

To be brief, the main difference between the present economic system and the Islamic economic system is that the later is based on keeping in view certain social objectives for the benefit of human beings and society. Islam, through its various principles, guides human life and ensures free enterprise and trade. That is the reason why the conventional banker does not have to be concerned with the moral implications of the business venture for which money is lent.

The Islamic financial system is based on equity whereas the conventional banking system is loan based. Islam is not against the earning of money. In fact, Islam prohibits earning of money through unfair trading practices and other activities that are socially harmful in one way or another.\(^\text{62}\)

**2.3.2 Pre-requisites of Islamic Finance**

The simple rules regarding Islamic finance can be summed up as follows:

**a) Any predetermined payment over and above the actual amount of principal is prohibited.**

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

In short, the prohibition of usury or interest (*riba*) is the most significant principle of Islamic finance. *Riba* translates literally from Arabic as an *increase, growth or accretion*. In Islam, lending money should not generate unjustified income. As a *Shari‘ah* term, it refers to the premium that the borrower must pay to the lender along with the principal amount, as a condition for the loan or for an extension in its maturity, which today is commonly referred to as interest.

*Riba* represents a prominent source of unjustified advantage. All Muslim scholars are in consensus that this prohibition extends to all forms of interest and that there is no difference between interest-bearing funds for the purposes of consumption

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or investment, because Sharia does not consider money a commodity for exchange. Instead, money is a medium of exchange and a store of value.

Thus the prohibitions against interest aim to promote justice in distribution. Islamic law does not distinguish between high rates of interest (characterized as usury) and lower rates. Any excess over and above the sum lent is disallowed.

b) The lender must share in the profits or losses arising out of the enterprise for which the money was lent.
Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. As defined in the Shari'ah, or Islamic law, Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, farms, service companies or simple trade deals. Translated into banking terms, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures. This is unlike the interest-based commercial banking system, where all the pressure is on the borrower: he must pay back his loan, with the agreed interest, regardless of the success or failure of his venture.

The principle which thereby emerges is that Islam encourages investments in order that the community may benefit. However, it is not willing to allow a loophole to exist for those who do not wish to invest and take risks but rather content with hoarding money or depositing money in a bank in return for receiving an increase on these funds for no risk (other than the bank becoming insolvent). Accordingly, under Islam, either people invest with risk or suffer loss through devaluation by inflation by keeping their money idle. Islam encourages the notion of higher risks and higher returns and promotes it by leaving no other avenue available to investors. The objective is that high risk investments provide a stimulus to the economy and encourage entrepreneurs to maximise their efforts.
c) Making money from money is not Islamically acceptable.

Money is only a medium of exchange, a way of defining the value of a thing; it has no value in itself, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else. The human effort, initiative, and risk involved in a productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital rather than capital, meaning that money becomes capital only when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not capital and, as such, it is not entitled to any return (i.e. interest). Muslims are encouraged to purchase and are discouraged from keeping money idle so that, for instance, hoarding money is regarded as being unacceptable. In Islam, money represents purchasing power which is considered to be the only proper use of money. This purchasing power (money) cannot be used to make more purchasing power (money) without undergoing the intermediate step of it being used for the purchase of goods and services.

d) *Gharar* (Uncertainty, Risk or Speculation) is also prohibited.

Under this prohibition any transaction entered into should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions. Also, parties cannot predetermine a guaranteed profit. This is based on the principle of 'uncertain gains' which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are considered as un-Islamic and so are forward foreign exchange transactions because rates are determined by interest differentials.

A number of Islamic scholars disapprove the indexation of indebtedness to inflation and explain this prohibition within the framework of qard-el-hassan. According to those scholars, the creditor advances the loan to win the blessings of
Allah and expects to obtain the reward from Allah alone. A number of transactions are treated as exceptions to the principle of gharar: sales with advanced payment (bai’ bithaman ajil); contract to manufacture (Istisna); and hire contract (Ijara). However, there are legal requirements for the conclusion of these contracts to be organised in a way which minimises risk.

e) Investments should only support practices or products that are not forbidden—or even discouraged—by Islam. Trade in alcohol, for example would not be financed by an Islamic bank; a real-estate loan could not be made for the construction of a casino; and the bank could not lend money to other banks at interest.

A set of prohibitions on which Islamic finance paradigm is based can be summed up as follows:

i) Transactions in unethical goods and services;

ii) Earning returns from a loan contract (Riba/Interest);

iii) Compensation-based restructuring of debts;

iv) Excessive uncertainty in contracts (Gharar);

v) Gambling and chance-based games (Qimar);

vi) Trading in debt contracts at discount, and;

vii) Forward foreign exchange transactions.

2.3.3 Distinguishing Features of Islamic Banking

An Islamic bank has several distinctive features as compared to its conventional counterpart. Chapra has outlined six essential differences as below:

a) Abolition of interest (Riba): Since Riba is prohibited in the Quran and interest in all its forms is akin to Riba, as confirmed by fiqaha and Muslim

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economists with rare exceptions, the first distinguishing feature of an Islamic bank must be that it is interest-free.

b) Adherence to public interest: Activity of commercial banks being primarily based on the use of public funds, public interest rather than individual or group interest will be served by Islamic commercial banks. The Islamic banks should use all deposits, which come from the public for serving public interest and realizing the relevant socio-economic goals of Islam. They should play a goal-oriented rather than merely a profit-maximizing role and should adjust themselves to the different needs of the Islamic economy.

c) Multi-purpose bank: Another substantial distinguishing feature is that Islamic banks will be universal or multi-purpose banks and not purely commercial banks. These banks are conceived to be a crossbreed of commercial and investment banks, investment trusts and investment-management institutions, and would offer a variety of services to their customers. A substantial part of their financing would be for specific projects or ventures. Their equity-oriented investments would not permit them to borrow short-term funds and lend to long-term investments. This should make them less crisis-prone compared to their capitalist counterparts, since they would have to make a greater effort to match the maturity of their liabilities with the maturity of their assets.

d) More careful evaluation of investment demand: Another very important feature of an Islamic bank is its very careful attitude towards evaluation of applications for equity oriented financing. It is customary that conventional banks evaluate applications, consider collateral and avoid risk as much as possible. Their main concern does not go beyond ensuring the security of their principal and interest receipts. Since the Islamic bank has a built in mechanism of risk sharing, it would need to be more careful in how it evaluates financing requests. It adds a healthy dimension in the whole lending business and eliminates a whole range of undesirable lending practices.
e) Work as catalyst of development: Profit-loss sharing being a distinctive characteristic of an Islamic bank fosters closer relations between banks and entrepreneurs. It helps develop financial expertise in non-financial firms and also enables the bank to assume the role of technical consultant and financial adviser, which acts as catalyst in the process of industrialization and development.

For the sake of simplicity, the distinguishing features of the conventional banking and Islamic banking are shown in terms of a box diagram as shown below:

Table-2

Comparison Between Conventional & Islamic Banks

<table>
<thead>
<tr>
<th>Conventional Banks</th>
<th>Islamic Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The functions and operating modes of conventional banks are based on manmade principles.</td>
<td>1. The functions and operating modes of Islamic banks are based on the principles of Islamic Shariah.</td>
</tr>
<tr>
<td>2. The investor is assured of a predetermined rate of interest.</td>
<td>2. In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).</td>
</tr>
<tr>
<td>3. It aims at maximizing profit without any restriction.</td>
<td>3. It also aims at maximizing profit but subject to Shariah restrictions.</td>
</tr>
<tr>
<td>4. It does not deal with Zakat.</td>
<td>4. In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to collect and distribute Zakat.</td>
</tr>
<tr>
<td>5. Leading money and getting it back with interest is the fundamental function of the conventional banks.</td>
<td>5. Participation in partnership business is the fundamental function of the Islamic banks.</td>
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<tr>
<td>---</td>
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</tr>
<tr>
<td>6. Its scope of activities is narrower when compared with an Islamic bank.</td>
<td>6. Its scope of activities is wider when compared with a conventional bank. It is, in effect, a multi-purpose institution.</td>
</tr>
<tr>
<td>7. It can charge additional money (compound rate of interest) in case of defaulters.</td>
<td>7. The Islamic banks have no provision to charge any extra money from the defaulters.</td>
</tr>
<tr>
<td>8. In it very often, bank’s own interest becomes prominent. It makes no effort to ensure growth with equity.</td>
<td>8. It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.</td>
</tr>
<tr>
<td>9. For interest-based commercial banks, borrowing from the money market is relatively easier.</td>
<td>9. For the Islamic banks, it is comparatively difficult to borrow money from the money market.</td>
</tr>
<tr>
<td>10. Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations.</td>
<td>10. Since it shares profit and loss, the Islamic banks pay greater attention to developing project appraisal and evaluations.</td>
</tr>
<tr>
<td>11. The conventional banks give greater emphasis on credit-worthiness of the clients.</td>
<td>11. The Islamic banks, on the other hand, give greater emphasis on the viability of the projects.</td>
</tr>
<tr>
<td>12. The status of a conventional bank, in relation to its clients, is that of creditor and debtors.</td>
<td>12. The status of Islamic bank in relation to its clients is that of partners, investors and trader.</td>
</tr>
<tr>
<td>13. A conventional bank has to guarantee all its deposits.</td>
<td>13. Strictly speaking, and Islamic bank cannot do that.</td>
</tr>
</tbody>
</table>

### 2.3.4 Acceptability of Dealing with Islamic Financial Institutions:

As we have seen, Islamic financial institutions abide by the permissible transactions in *shari‘ah* and avoid the forbidden transactions. Moreover, they serve a vital economic need of the poor in the economy, while providing a valuable service in mobilizing savings and encouraging investment and growth in the economy.

It is well known that the original status of all economic contracts is permissibility unless ruled otherwise. Thus, since the transactions of Islamic financial institutions are far from the forbidden *riba*, and they provide useful economic tools to meet the economic needs of Muslims, they are permissible. In this regard, *shari‘ah* does not forbid anyone from making reasonable profits (up to 20% or 33%). While some people doubt that certain types of profits made from Islamic banks may seem similar to *riba*, we note that as long as the means used to obtain those profits are permissible, the transactions are permissible. Thus, while some may argue against the increase in price for deferment in *Murabahah* contract, we say that the Muslim jurists permitted such transactions to meet the economic needs of Muslims. Such contracts are not exploitative, on the contrary, they help the consumer to obtain goods that he would not otherwise be able to consume.

Similarly, commissions and fees that Islamic financial institutions charge for their services may be thought by some to be forbidden *riba*. However, most of the activities of those institutions take the form of rental (e.g. of a deposit box or storage room) and hiring of labor services (e.g. in maintaining such space, or preparing
paperwork for transactions), or agency in exchange for a fee. All such fees and commissions are permissible and should not be confused for the forbidden riba.

For structural differences between the financial characteristics of interest-free banks and conventional banks, see M.M. Metawali (1997). In his paper, covering 15 interest-free banks and 15 conventional banks, the analysis extends to various financial dimensions which evaluate performance, namely: liquidity, leverage, credit risk, profitability and efficiency. And the statistical evidence suggests that the two groups of banks may be differentiated in terms of liquidity, leverage and credit risk, but not in terms of profitability and efficiency.

2.3.5 The Advantages of Islamic Finance:

Justice and fairness to all concerned is the main feature of a model of financial intermediation whose core is profit-sharing. Interest is essentially unfair because our environment does not guarantee positive returns to business enterprise financed with borrowed money capital. Current practice penalizes entrepreneurship by obliging it to return the principal even when part of it is lost due to circumstances beyond the entrepreneur’s control. Justice requires that money capital seeking profit share the risk attached to profit-making. A just system of financial intermediation will contribute to a more equitable distribution of income and wealth.

Islamic finance will foster greater stability as it synchronizes the payment obligations of the entrepreneur with his revenues. This is possible only when the obligation to pay back the funds acquired from the financier and also pay a profit is related to the realization of profits in the project in which the funds are invested, as is the case in the profit-sharing model.

In contradiction to this, in the debt-financing model the payment obligations of the entrepreneur are dated and fixed in amount. The same is true for financial

intermediaries, whose commitment to the depositors in time and savings accounts is to pay back the sum deposited with interest added. When a project fails and a business person defaults, the financial intermediary must also default, and the ripple effects destabilize the whole system. The debt-based financial system of capitalism is inherently prone to recurrent crises. This malaise of the capitalist financial system is well discussed by Hyman P Minskey. By linking the depositors’ entitlements to the actual profitability of the projects in which their monies are invested through the services of the financial intermediary, a bank would almost eliminate the risk of runs on the bank insofar as the investment accounts are concerned. A report or a rumor that the bank’s investments were not doing well would not prompt a rash of withdrawals from investment accounts, since depositors would only be able to get what was actually salvageable. A more rational option would be to wait until the situation improved.

Islamic finance is more efficient in that it allocates investable funds on the basis of the expected value productivity of projects rather than on the criterion of the creditworthiness of those who own the projects, which is the case in debt-based finance. There is no guarantee that the most promising projects seeking finance will come from the most wealthy. Indeed, the most innovative may be empty-handed, but debt finance does not serve them. It prefers those who, on the basis of other assets they own, are able to pay back the sum borrowed with interest added, even when the project being financed fails to create additional wealth.

Finally, Islamic finance is less prone to inflation and less vulnerable to speculation, which are currently being fueled by the presence of huge quantities of debt instruments in the market. Debt instruments function as money substitutes, while equity-based financial instruments do not. And speculators find it much easier to manipulate debt instruments than those based on profit-sharing.

It is true that these advantages belong to a system whose core is profit-sharing. But even Murabahah (cost-plus or mark-up) financing keeps the system far less vulnerable to inflation and gambling (e.g., speculation) than do conventional debt-based arrangements. Murabahah is firmly linked with the exchange of real goods and services. It is a price, to be paid later. It is essentially different from money given as a loan which may or may not be linked to the production or exchange of real goods and services. An Islamic system of finance in which profit-sharing and mark-up financing exist side by side will still retain the advantages noted above.66

Mabid Ali al-Jarhi, Islamic Research and Training Institute has classified some advantages of Islamic Finance under different heads examining Islamic finance from several sides such as efficiency, stability, moral hazard and adverse selection, role in economic development, integrity, equity and sustainability that are as follows67:

1) Efficiency

At the macroeconomic level, Islamic finance avoids the use of interest-based lending. The rate of interest is replaced by the rate of profit on equity and profit-sharing finance, by markups on credit-purchase finance and by rental rates on leasing finance. While the time-value of money is maintained, there is no need to handle the complicated questions of how to bring the rate of interest down to zero in order to reach the optimal allocation of resources.

Conventional finance allocates financial resources with paramount regard for borrower’s ability to repay loan principal and interest. In modes of Islamic finance that are based on equity and profit sharing, focus would be on the profitability and rate of return of the concerned investment. This type of finance has the potential of

directing financial resources to the most productive investments. This would increase
the efficiency of the financing process and reinforce efficiency in the real sectors.

2) Stability

A conventional bank has on the one hand liabilities that include demand, time
and saving deposits, which the bank guarantees. On the other hand, it has assets that
are mostly composed of debt instruments each of which has a quality that depends on
the ability of the corresponding debtor to repay. Default on the asset side, if it
happens in significant proportion, would imply inability to meet the bank’s
obligations on the liability side. Such default can be expected at times of crises, be it
of macroeconomic nature or caused by circumstances specific to the bank. A bank
operating according to Islamic rules of finance has liabilities of different nature. Only
demand deposits are guaranteed. Meanwhile, investment deposits are placed on
profit-and-loss sharing basis. When such bank faces macroeconomic or specific
crises, investment depositors automatically share the risk. The bank is less likely to
fall and a bank run is less probable. It can therefore be said that an Islamic banking
system is relatively more stable when compared to conventional banking.68

In conventional finance, present money is traded in an integrated debt market
against future money, which takes the shape of commitments to pay specified
amounts at specified future dates, or bonds. Bonds are supposed to be easily traded
financial instruments, many of which are listed in international financial markets.
Hundreds of billions of dollars of debt are traded daily in those markets. Bonds
markets provide an easy and automatic mechanism through which short-term funds
flow at will from one country to another. Much of those flows follow factors that are
only nebulously related to economic fundamentals. They bring an important element
of instability into national economies. They threaten the world economy with the
spread of instability that might start in one single debt market in a fashion that
economists have come to call “contagion”.

The integrated debt market has grown immense in size as well as in scale of integration that now encompasses the whole world economy. Many experiences, as lately manifested in the Southeast Asian economies, have shown that integrated debt markets are sources of both domestic financial instability and contagion. Some economists have come forward with proposals to place restrictions on capital movements in contrary with what has been considered in economics as received doctrine.

In contrast, debt is created in Islamic finance through selling goods and services on credit. Resulting debt instruments are not readily tradable. We can visualize the existence of a credit market for each commodity and service in which the demand and supply to buy it on credit determines a mark-up rate. Such credit markets would be fully segmented, while the debt instruments themselves are traded only for nominal values at maturity. There is no room for sudden and mass movements of funds. Possibilities of instability and contagion through the debt market would therefore be remote and the justifications to choke capital movements with restrictions become unnecessary.

Examination of daily records of trading in financial markets vividly shows that institutional participants carry out huge speculative transactions. More often than not, such transactions are sources of instabilities. In contrast, Islamic financial institutions are automatically prevented from carrying out such gambling activities; destabilizing speculations would be significantly curtailed in financial markets.

We have noted above that Islamic finance never provides present money in return for future money. All Islamic modes of finance involve money on the one end and goods and services on the other. Monetary flows through Islamic financial modes would have to be tied directly with commodity flows. In other words, Islamic finance removes the dichotomy between financial and real activities. Obviously, this leaves

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69 At maturity both counter-values, viz., debt and its nominal value would be spot and equal in amount, thereby fulfilling the necessary conditions for trading money in Islam. Meanwhile, debt can be swapped against tangible goods or services (according to Imam Malik and Ibn Taymiah), but not for cash.
little room for excessive credit expansion, as the finance extended is automatically earmarked for specific uses.

Speculative activities related to interest rate expectations would become out of place. Changes in spending would automatically be reflected on changes in demands and supplies of goods and services, causing quantities of output produced to respond more quickly to market forces. In other words, markets are more likely to operate efficiently and smoothly. It is therefore interesting to note that Islamic finance, though non-conventional, supports market forces and mechanisms more than does conventional finance.

3) **Moral Hazard and Adverse Selection**

We have mentioned above that Islamic banks hold equity and trade in goods and services as they operate as universal rather than commercial banks. Universal banks are defined as “large-scale banks that operate extensive networks of branches, provide many different services, hold several claims on firms (including equity and debt), and participate directly in the corporate governance of the firms that rely on the banks as sources of funding or as securities underwriters”.  

A bank can be exposed to moral hazard when the firm obtaining finance uses the funds for purposes other than those for which finance was advanced. This could lead to business failure and inability to repay on part of the debtor firm. The bank would be exposed to adverse selection when it fails to choose the finance applicants who are most likely to perform.

Obviously, adverse selection can be avoided by careful screening of finance applicants. When a bank provides equity and debt finance simultaneously, it will have more access to information than when only debt finance is provided. We can therefore conclude that screening would be more effective and adverse selection less probable with universal banking.

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Reducing possibilities of moral hazard requires monitoring the firm that obtains finance. All three kinds of ex ante, interim and ex post monitoring must be exercised to be effective. Equity finance provides the bank with access to information necessary to practice monitoring at all intervals. It also reduces the firm incentives to substitute riskier for safer assets. Meanwhile, debt finance would reduce the firm incentives to hide its profits. Furthermore, when the firm faces problems, the bank, as an equity holder, will assist in order to protect its investment.

In summary, banking theory indicates that universal banking would be exposed to lower levels of moral hazard and adverse selection. In addition, by sitting on the firms' board of directors, banks could influence corporate governance in the whole productive sector, leading to improvements in economic performance.

Empirically, it has been found that using a combination of debt and equity finance by banks seems to carry several advantages to both banks and firms, confirming theoretical findings. Banking theory would indicate that banks would be relatively more exposed to adverse selection during economic upturns and to moral hazard during downturns. Applied research has found that universal banks face lower risk than commercial banks during both upturns and downturns. In addition, the risk differential between universal and commercial banks gets wider and more significant during downturns.

4) Finance and Development

Given the characteristics of Islamic finance mentioned above, particularly the fact that Islamic banks operate according to the rules of universal rather than commercial banking, we can ask which system gives better support to economic


entrepreneurial efforts to develop the economy. Empirical findings seem to confirm such intuition.

Calomiris (2000), through his study of pre-World-War I Germany, has found that universal banking served to reduce the cost of financing industrialization in Germany relative to its corresponding level in other countries where commercial banking is prevalent. He also found that the financial sector reached a higher level of allocative efficiency in the former than in the latter country. We can therefore rest assured that banks operating as universal banks give better support to development efforts.

It is widely accepted that economic development requires mobilization of vast financial resources both internally and externally. Any financial resources left hoarded would imply unrealized potential for economic development. As Islamic teachings emphatically prohibit trading present for future money at a rate of interest, many Muslims hold their funds outside the banking and financial sector, thereby missing an opportunity to apply those funds to the development process. Islamic finance opens the door to the effective use of much needed financial resources within many Islamic countries that would be otherwise kept idle. In addition, it provides Muslims with a way through which they can participate in the development process without exceeding their religious beliefs. Muslim minorities in other countries, whose banking systems do not provide Islamic financial products, suffer from cultural exclusion. Some of those Muslims may have to keep their savings outside the financial system thereby contributing to idle financial resources in their countries.

5) Integrity

Conventional finance can be likened to a spectator’s game where few skilled players stay in the playground and a big crowd is watching from outside. Islamic
finance, meanwhile, is similar to participatory sports, where every one is playing and no one is concerned with mere watching. In addition, there is a moral side to Islamic finance that seems to be in the back of mind of everyone.

Risk is known to be one of the most important ingredients of making investment. Those who finance investment share a good part of the risk involved with those who carry out actual investment activities. Conventional finance leaves risk to be borne by specialists. Banks and financial institutions provide investors with loans guaranteed by collateral. In this fashion, they keep themselves apart from certain kinds of risk, like those attached to production, marketing and distribution, and limit their exposure to risk related to collateral only.

Islamic finance allows savers who deposit their funds to share with banks the risks associated with choosing the right investment and how successful it would be. Banks and financial institutions advancing funds share risk with those receiving finance, including producers, traders, and the like. Islamic finance with proper corporate governance allows depositors some influence on banks investment decisions and allows banks and financial institutions a share in the decision making process, by sitting on the boards of directors of firms receiving funds.

We can therefore notice that risk as well as decision-making is spread over a much larger number and wider variety of concerned people. Risk sharing is balanced by sharing in decision-making. This allows for wider involvement in economic activities, so that people will eventually feel they are partners rather than spectators.

The benefit of wider involvement goes beyond the mere feeling of involvement. It adds to the stability of banks. Holders of investment deposits with banks share in both the profits and losses. When a bank faced the unlikely event of an overall loss over the placement of its investment pool, its depositors shoulder their proportional share of the loss. Individual banks as well as the banking system as a whole would therefore be less likely to break down.
6) Equity

Islamic financial institutions must be viewed as basically private profit-seeking business enterprises that operate according to the market mechanism. By themselves, they cannot reduce, let alone, eradicate poverty. However, if given the right tools, they can contribute to the efforts taken by the whole society in that regard.

Islam prescribes a tax-subsidy approach to reducing poverty. A levy called Zakah is paid out by the wealthy (those whose wealth exceeds a certain minimum level) in proportion to their property.

Zakah proceeds are to be earmarked for several uses including income and wealth maintenance for the poor. Income maintenance is provided within narrow limits to those incapable of work and wealth maintenance is provided to the rest of the poor. The latter policy entails giving the poor productive assets, which they can use to produce goods and services and sell them for profit. This method of poverty reduction can be closely intertwined with that of economic development, as redistribution is mostly directed towards making the poor more productive, which in turn contributes to economic development.

Income maintenance would involve regular (monthly) payments to the needy. Wealth maintenance, meanwhile, involves transferring to the poor a combination of productive resources, which would be capable of generating sufficient income to maintain at least one household.

Zakah collection would be expected to be carried out mostly by nongovernmental and sometimes by governmental organizations. Islamic banks can help by acting as custodians and in the disbursement of the proceeds. In addition, non-banking financial institutions can also take part in collecting Zakah, using Islamic banks as depositories, and invest the proceeds allocated to the poor in special accounts with Islamic financial institutions, to which they would also add a
proportion of Zakah due on their shareholders equity. They can even accept direct payments of Zakah and other donations on behalf of philanthropic institutions.

As to income maintenance, Islamic banks and financial institutions can credit the accounts of the prescribed poor with monthly payments. Wealth maintenance can be implemented through the establishment of micro enterprises that would be owned and operated by the poor. While, the titles to such enterprises are transferred to the poor, certain measures must be taken to insure that the new businesses would not be immaturity liquidated to finance consumption outlays for their owners. The experience of Islamic banking and financial institutions in project financing should come in handy in eradicating poverty and increasing equity through proper use of Zakah proceeds.

Conventional lending gives utmost attention to the ability to repay loans. To ascertain such ability, it depends overwhelmingly on the provisions of collaterals and guarantees. Thus those already rich would have most access to finance. In contrast, Islamic finance providing funds on equity or profit-sharing basis would be more concerned about profitability and rate of return and less concerned about collateral as the primary consideration. Those who are not wealthy, but have worthy investment projects, would have more access to finance.

7) Sustainability

Conventional debt has certain characteristics that could place debtors in difficulties if circumstances do not allow them to repay in time. Interest is usually calculated on the outstanding balance of debt, usually compounded annually and sometimes at shorter intervals. Delinquent debtors are often subjected to penalty rates of interest, which are higher than regular rates. It is not uncommon to find borrowers who end up paying debt service that is many folds the original principal they

Understandably, there may be other expenditures items which would be financed from zakah proceeds. That is why only a proportion of them would be handed to collectors. Such proportion can be determined by society and could change from year to year.
to debtor countries. Despite continuous efforts, the debt problems faced by developing countries seem to be ever-present.

We can therefore conclude that interest based financing lacks a great deal of sustainability. Creditors have to stop every few years to give debtors relief in terms of rescheduling and forgiveness. Sometimes this also includes floating low quality debt at lower market value and swapping it with equity. The system has demonstrated unsustainability several times.

Unconventional debt created through Islamic finance has characteristics with which debt crises are less likely to rise. Particularly, the total value of debt, which includes the spot value of commodities purchased on credit as well as an implicit mark-up, is set from the very beginning. The total value of debt can be repaid in installments, without increase in its total value, as there is no compounded interest to pay on outstanding balance.

When debtors face unavoidable circumstances that would make them temporarily insolvent, they are often granted grace periods to help them bring their finances back to order. No penalty fees can be levied in this case. In other words, debt rescheduling, when justifiable, would be granted at no extra cost to borrowers. Therefore, we can conclude that Islamic finance is sustainable and less liable in itself to cause undue hardship to debtors.

Quite often, conventional debt cannot be repaid because it was not used for its prescribed purpose. Under the rules of conventional finance, creditors assume that the use of the loans they extend would strengthen the ability of debtors to meet their future obligations. However, conventional loans are usually offered without ways or
mechanisms to assure their use for certain purposes. In contrast, Islamic debt is created through the finance of acquiring goods and services on credit. In other words, the loan is used from the very beginning for its prescribed purpose. Default resulting from improper use of borrowed funds would therefore be most unlikely.

As Islamic finance provided to finance investment is asset-based, i.e., it is used to acquire real assets; it is much less likely to lead to debt crises. Such type of asset-based finance, directly contributes to the ability of the economy to meet its internal and external financial obligations. This is certainly a welcome effect.

2.4 Some Basics related to Sale: Definition; Types; Ethics; Basic Rules

Since Murabahah is originally a sale contract, it is, therefore, imperative to discuss some basics concerning sale.

2.4.1 Definition of Sale

A sale (bay) is an exchange of one item for another. The Arabic term “bay” refers both to the activities of buying and selling.

- For the Hanafis, it means the exchange of an owned commodity (maal) for another in a specified manner; or the exchange of an owned commodity for another in a beneficial and special manner. This excludes unbeneﬁcial exchanges (e.g. the exchange of one coin for an identical one), or the exchange of bads (i.e. items of no worth, e.g. dead animals, or dust)

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74 In cases where a loan is earmarked for the purchase of commodities, a conventional bank would find it cheaper to enforce earmarking through a sale-finance contract.


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Al-Nawawi defined sale as “the exchange of an owned commodity for another with the exchange of ownership”\textsuperscript{77} Ibn-e Qudamah defined it similarly, emphasizing both the exchange of ownership, and taking possession by the new owner.\textsuperscript{78}

Professor Al-Zarqa, a Shariah expert defined the sale as follows:

“An owned commodity is any identifiable object with a material value for the people”\textsuperscript{79}. A sale always means a contract consisting of an offer (eijab) and an acceptance (qabul).

Mufti Muhammad Taqi Usmani, another contemporary \textit{shariah} expert defines it with the following: “the exchange of a thing of value by another thing of value with mutual consent”\textsuperscript{80}.

The general rule in sales is permissibility as it allows each individual to meet his needs in cooperation with others trying to meet their own.

Al-Imam Al-Shafii ruled: “The general rule for all sales is permissibility as long as they are concluded by consenting capable decision makers, except for what the Messenger of Allah (pbuh) has forbidden, or what is sufficiently similar to that which the Messenger of Allah (pbuh) has forbidden; and anything different from those is permissible following the permissibility of sales stated in the book of Allah Almighty (meaning the verses [2:275], [2:282], [4:29], & [2:198]).\textsuperscript{81}

\subsection*{2.4.2 Types of Sale}

\textsuperscript{77} Al- Kahateeb al- Shirbini ((Shafi’i)), “Hasitay al-Bijirmi ala Sharh alOqlana fi- Hall alfaz Abi Shuja’” vol. 2, p. 2 (as cited by Zuhaili, op. cit., p.5)
\textsuperscript{78} Al- Kahateeb al- Shirbini ((Shafi’i)), vol. 3, p. 559 (as cited by Zuhaili, p. 5)
\textsuperscript{79} See the introduction of his Nazariyya al-Itizam al- Ammah fi al- Fiqh al-Islami (pp.114-118).
\textsuperscript{80} Usmani, (2005) op. cit, p. 97
\textsuperscript{81} Zuhaili, (Tr. By El-Gamal), op. cit, p. 7
The classical jurists categorized sales into *Musawamah* (bargaining) and *Amanah* (trust). We begin with quoting what a specialized dictionary entry on the subject of *amanah* sales or sales of trust explain\(^2\):

“The classical jurists categorized sales, with regard to the way prices are determined, as either sales in which trust, *amanah*, is the key element, or sales in which bargaining, *musawamah*, is the key element. Sales of bargaining are sales in which the seller does not disclose the amount of his investment in whatever he is offering for sale. In such a sale, both parties will agree to transact for a certain price, without the seller’s disclosing to the buyer the price he originally paid for the goods or whatever it is he is offering for sale. Ibn Jazzi, the Maliki jurist, defined *Musawamah* as “the buyer’s negotiating with the seller over a price until they come to an agreement on it, without there ever being mention of how much the seller originally paid for the goods.” In sales of trust, however, the price is specified as being the same as the seller’s investment, or more, or less. Such sales are called sales of trust because the seller is to be taken at his word when he informs the buyer what he paid for the goods for sale.”\(^3\)

Let us see the consideration in sales of this nature. According to Prof. Shacht,

“The main consideration in all such sales is the exclusion of dishonest, unjustified enrichment.”\(^4\)

Let us now turn to another encyclopedia entry for the purpose of furthering our understanding of *amanah*.

The lexical meaning of *amanah* or trust is the opposite of betrayal, and it denotes any legal responsibility charged to a person, including acts of worship or entrusted property. The classical jurists, however, used the word in two ways; as a noun, and as an adjective. The meaning of trust, as a noun, is that which is kept with

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a trustee. As an adjective, the term is used to denote trust sales, like Murabahah, in which the purchaser depends on the conscience of the seller and trusts his/her truthfulness. The Almighty stated in the Qur'an: O you who believe! Do not be false to Allah and His prophet, and do not knowingly be false to the trust that has been reposed in you (8:27). Moreover, the Prophet, upon him be peace, said, “He is not one of us who attempts to cheat us.” This Hadith was related by Muslim, Abu Dawud, and Ibn Majah, from Abu Hurairah.

It is for this reason that if any sort of misrepresentation should be discovered in a muabahah sale, the buyer would have the option to retain the goods he/she purchased, or to return them. Some scholars have added that the buyer will have the further option to subtract from the price whatever extra amount was falsely reported as the original purchase price, and then to subtract a corresponding percentage from the agreed upon margin of profit. Details of the same may be seen in Kashani 5/223, Ibn Qudamah 4/203, Dasuqi 3/164, and Nawawi, Al-muhadhdhab 1/295.

To explain further, sales of trust are of three kinds: Murabahah (Cost-plus), Tawliyah (investiture) and Wadi’ah (resale with loss).

Tawliyah (investiture) refers to a sale in which the value of goods as represented by the seller is itself set as their price, with no profit or loss. Alternatively it may be described as resale at the stated original cost.

Wadi’ah (resale with loss) refers to a sale in which the price is set at less than what the seller says in the value of goods, or resale with a rebate on the stated original cost. While Murabahah is a resale with a stated surcharge that represents the profit. Murabahah is resale with a stated surcharge that represents the profit.

The above mentioned categories of sales (with respect to the price) may be summed up as follows:

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82 Kuwaiti Fiqh Encyclopedia, (Kuwait: Ministry of Endowments and Islamic affairs, 1988) vol. 6, pp. 236-239
86 ibid.
a) Negotiation or bargaining sale (bay al-musawamah): It is the sale at the agreed upon price without reference to the original price of the commodity. This is the most common type of sale.

b) Cost-plus sale or Mark up (bay al-Murabahah): It is the sale of an object at the price at which it was obtained plus a stated profit margin.

c) At-cost sale or investiture (bay al-tawliyah): It is the sale of an object at the same price originally paid for it by the seller. In other words, the object is resold to the buyer for the same price at which the seller obtained it; thus its name suggests that the seller lets the buyer takes his place (yatawalla) in the original sale.

d) Below-cost sale, or sale at a loss (bay al-wadiah): It is sale of an object at a price below the price for which the seller bought it, i.e. at a given loss. Thus the object is sold with a known discount below the original price.

Abdullah al-Musali says: “Since Murabahah, tawliyah and wadi’ah are based on trust where buyer has to fully rely on the seller being informed with the original purchase price of the goods, the seller, therefore, must be a person having no breach of trust.”

2.4.3 Ethics of Sales

There are many ethical considerations in sales, including:

a) The avoidance of excessive profits: All religions prohibit excessive taking of advantage of buyers as forms of cheating. However, a moderate degree of such taking of advantage is admissible because otherwise, all trade would cease. However, if one side takes too much advantage of the other, the sale may be deemed void. The Maliki scholars defined excessive disadvantage as a

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profit of one third or more, since that corresponds to the rules of limited will.\textsuperscript{88} Therefore, a profit rate of one third or less is considered acceptable.

b) **Truthful and complete disclosure of information:** The seller must give full and truthful information about the product, including its type, origin, and cost. Al-Tirmidhi reported the following Hadith on the authority of Rifa‘a: “All merchants are resurrected on the day of judgments as sinners, except for those who feared Allah, treated their customers well, and were truthful”.\textsuperscript{89}

c) **Documentation and witnessing of all debts:** It is desirable that all contracts and loans be written, and that witnesses sign for all delayed sales and debts, as Allah has prescribed in His Book.\textsuperscript{90}

### 2.4.4 Basic Rules of Sale\textsuperscript{91}

Being a sale, Murabahah is governed by all rules and regulations common to sales in Shari‘ah. For a proper understanding of Murabahah, it is necessary to have a clear knowledge of the provisions of Islamic law pertaining to sales. Islamic law has laid down enormous rules governing the contract of sale, and the Muslim jurists have written a large number of books, in a number of volumes, to elaborate them in detail. Some important rules\textsuperscript{92} may be summarised as follows.

1. **The object of sale must exist at the time of contract:** Only an item that is existent at the time of sale could become the subject of a valid sale transaction. This means that a non-existent thing may not be sold, even on Murabahah. Thus, the sale of non-existent objects such as the produce of the produce may not be effected. Also, the sale of items that may exist and may

\textsuperscript{88} Ibn al-Arabi, ‘Ahkam Al-Qur’an (vol. 4, p. 1804) as cited by Zuhaili, (Tr. By El-Gamal) op. cit. p. 7
\textsuperscript{89} ibid.
\textsuperscript{90} Al-Qur’an [2:282]
\textsuperscript{91} This section largely benefit from the book of al-Zuhaili, Usmani, Muhammad Ayyub & others.  
\textsuperscript{92} All these and other rules & conditions related to sale have been treated at length in al- Zuhaili, (Tr. By El- Gamal) op. cit, Chapter 2 ‘Condition of Sale’, p. 13-35. The standpoints & opinions of all four schools of Islamic Jurisprudence have been dealt separately. The said book also dilate upon the issues like condition of conclusion, eligibility of the parties, correspondence of acceptance to the offer, unity of the contract session, condition for the executability of sale, condition for validity, condition for bindingness, Agreement & differences in sale conditions (in relation to all four schools); also refer to Usmani, M.T. p. 97-101.
vanish (e.g. an unborn lamb in the womb or milk in an udder) may not be concluded.

2. **The object of sale must be in the ownership of the seller:** The sold item should necessarily be in the ownership of the seller, and the seller should bear the risk pertaining to it at the time of sale.

3. **The object of sale must be in the physical or constructive possession of the seller:** The seller should have the item in his possession at the time of sale, either by having physical possession or by having constructive possession. The essence of the above mentioned rules pertaining to sale of a commodity may be summed up as follows:

(a) It is existent.
(b) It is owned by the seller.
(c) It is in the physical or constructive possession of the seller.

Here Mufti Muhammad Taqi Usmani remarks adding a note on the basis of the resolution of Vth session of Islami Fiqh Academy:

“There is a big difference between an actual sale and a mere promise to sell. The actual sale cannot be effected unless the above three conditions are fulfilled. However one can promise to sell something which is not yet owned or possessed by him. This promise initially creates only a moral obligation on the promisor to fulfill his promise, which is normally not justifiable. Nevertheless, in certain situations, specially where such promise has burdened the promise with some liability, it can be enforceable through the courts of law. In such cases the court may force the promisor to fulfill his promise, i.e. to effect the sale, and if he fails to do so, the court may order him to pay the

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93 In constructive possession, the item is in the control of holder without having physical delivery and he become responsible for all the rights and liabilities pertaining to the item including the risk of its destruction. For Example, A purchases a car from B. B puts it in a garage to which A has free access and he can take the delivery from that place whenever he wishes. Thus the risk of the Car passes on to A and the car is now in the constructive possession of A. If A sells the car to C without acquiring physical possession, the sale is valid.

94 Resolution no. 2,3 of the Fifth Session of the Islamic Fiqh Academy, held in Kuwait in the year 1409 AH. See Majallah al-Fiqh al-Islami, vol.5. (2:1599)
promise the actual damages he has incurred due to the default of the promisor.

But the actual sale will have to be effected after the commodity comes into the possession of the seller. This will require separate offer and acceptance, and unless the sale is effected in this manner, the legal consequences of the sale shall not follow.⁹⁵

4. The object of sale must be deliverable at the conclusion of sale: A sale is not valid if the object is impossible to deliver even if owned by the seller. Since that which is not deliverable is comparable to that which does not exist and the sale of the latter is not valid. Thus the sale of birds in the sky, fish in the water and a lost or stolen animal is void. Likewise, the delivery of the sold item to the buyer must be certain and should not depend on a contingency or chance.

5. The subject of sale must be pure and admissible: The article should be a legally valid subject of sale in Shari’ah. The object from which it is legal to derive benefit may be sold. Thus, the sale of wine and pork may not be concluded since their use is prohibited.

6. The subject of sale must be good and a property of value: The subject of sale should be accepted as a saleable item having a value. Thus, the sale of what may not be used to benefit the people or have no value according to the convention and usage of trade is void.

7. The object of sale and price must be explicitly known beyond dispute: The article of sale should be known and identified with certainty, with all necessary details and the price be clearly known and agreed.

Thus, it is not valid to sell an unknown such as one sheep in a herd or to sell with an unknown or unidentified price such as selling an item for its value. Similarly, if the price is uncertain, the sale is void.  

8. **No third party should have rights over the object of sale:** If anyone other than the owner has a legal right to ownership of the merchandise or its usufruct, then the contract is suspended. Hence, the seller cannot sell what he has pawned or rented.

9. **The contract should not have an expiration period:** A sale is defective if it has an expiration period. For instance, if the seller says: I sold you this house for a month for one thousand, the sale is invalid, since a sale must be limited in time and not timed. Ownership of a specific object does not have an expiration date.

10. **The contract should not contain a corrupting condition:** Corrupting conditions are those that lead to an extra benefit to one of the parties of the contract. They are forbidden since such benefit is not legally proscribed, not accepted conventionally, and not appropriate to the nature contracts. Thus, it is not valid to stipulate a condition that the sold animal be pregnant, that the object sold be used by the seller for a period after the sale, or that the buyer lends the seller an amount of money. Except when it has been specified in the law, accepted in custom and convention, required by the contract, or suitable for the transaction.  

In other words, the contract of a sale should be unconditional and not include any condition or clause that would invalidate the transaction in Shari’ah except the

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96 For Example, A says to B, "If you pay within a month, the price is Rs. 50. But if you pay after two months, the price is Rs. 55". B agrees. Here the price is uncertain and the sale is void, unless anyone of the two alternatives is agreed upon by the parties at the time of sale.

97 Professor Mustafa Al-Zarqa has commented on this topic saying: “Since conventions among people validate conditions in the opinion of some scholars, every condition that is originally defective becomes valid and binding if people make it a convention and use it often. Thus, we can say that the corrupting condition has been juristically eliminated in people’s dealings with the passage of time, and this age’s conditions have all become valid by the very fundamentals of Hanafi inference (ijtihad). (Aqd Al-Bay, p.28)
condition which is recognized as a part of the transaction according to the usage of trade.\(^8\)

Agreements in respect of sales for immediate payment are concluded by offer and acceptance and require that there be a statement as to a determinable quality and quantity. Delivery, for purposes of Shari’ah relates to the removal of obstacles by the seller between the purchaser and the object of the sale, allowing purchaser to take ownership and control of the object.\(^9\) As a general matter, the purchaser must have full access to or possession of the object with the full permission of the seller under applicable Hanafi, Maliki, and Shafi’i rules, while the Hanbali school is of the position that the taking of possession is determined in accordance with the nature of the property being sold and purchased.

### 2.4.5 Options (khiyar) of sale

The concept of al-khiyar (options) in Islamic law is basically ethical. Al-khiyar (option) generally refers to a specific type of right of either or both parties to the contract to confirm or rescind the contract. Of the various types of options, some are created by mutual consent of the parties to the contract, while others are in the nature of rights existing for either or both parties because of the very operation of the law. The equity of a contract and fulfillment of proper and reasonable expectations of the parties to the contract is of utmost importance. The parties to the contract must be reasonably certain and informed about the countervalues being exchanged, and the implications or outcomes of contracting. The presence of uncertainty or absence of relevant information is termed as gharar which may lead to the contract being invalid. The provision of al-khiyar helps reduce gharar and brings the contract within

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\(^8\) For Example, A buys a refrigerator from B, with a condition that B undertakes its free service for 2 years. The condition, being recognized as a part of the transaction, is valid and the sale is lawful.

\(^9\) Al-Zuhaili – El-Gamal, Volume 1, chapter 3, at pages 66-70. This discussion notes that “if a person purchases wheat in a house, and the seller gives him the key to the house saying: ‘I have given you full access and permission to take the object of sale’, then the buyer would have received the object of sale” (pages 66-67), and, in footnote 44, noting that giving full access and permission to the buyer is receipt by the buyer even if the buyer did not literally receive the property. This discussion notes a similar position by the Malikis and the Shafi’is with respect to access and permission, stating that delivery of the keys would constitute access and permission. The Hanbali position, as summarized in the same work, is that possession is determined by the nature of the property.
Islamically acceptable limits. It helps undo any possibility of wrong committed on a party deliberately or unintentionally. It has also several larger benefits to the society. Through options, the parties to the contract are granted a ‘reassessment’ or ‘cooling off’ period over which they can rationalize their decisions or reverse the same. Thus, the possibilities of conflicts between the parties because of their abrupt, irrational and wrong decisions are minimized.100

Broadly, the classical fiqh literature classifies options into the following categories, (though minor variations in the classification method have been reported by some scholars): khiyar al-shart (option by stipulation); khiyar al-tayeen (option of determination or choice); khiyar al-ayb (option for defect); khiyar al-ruyat (option after inspection); and khiyar al-majlis (option of session). Some scholars view khiyar al-tayeen only as a specific form of khiyar al-shart. Some authors discuss about two other options - khiyar al-wasf (option by misrepresentation) and khiyar al-tadlis (option by fraud); while others prefer to discuss these under the broad category of khiyar al-ayb.

To conclude, these different types of options (khiyarat) permitted under shari’ah may allow cancellation or ratification of the relevant contract and related transaction.101 These includes among others, options in respect of: (1) misdescription, (2) selection of property, (3) inspection (al-ru’ya), (4) defects, and (5) payment (including instalment payments).

Thus, the five options of sales as formalised in classical fiqh may be summarized as follows:

- Buyer’s option to rescind: time limited, seller has similar option, but cease before execution of contract;

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101 Al-Zuhaili - El-Gamal, Volume 1, chapter 5, at pages 165-231, which discusses the various types of options recognized by each of the four major school of jurisprudence (seventeen by the Hanafis, two by the Malikis, sixteen by the Shafi’is and eight by the Hanbalis). The option must be exercised within a defined time period.
• Option of inspection: the right to see and verify the object of the sale;
• Option of defect: right to return if defective;
• Option of quality: right to specified quality; and
• Option of price: right to fair price within market range.