

## **Islamic Shari'a Concepts governing Islamic Banking finance**

### **Introduction**

It is submitted that accepting Islamic Banking within the western regulatory framework has encountered many impediments. A conventional bank is an institution that holds a banking license issued by banks' regulatory authorities which authorizes the chartered institution to conduct fundamental banking services such as receiving deposits, making loans, providing and saving account services. The conventional bank pledges a predetermined return on deposits; however, in the Islamic banking system depositors receive a portion of the bank's deposits as opposed to interest.<sup>1</sup> In respect of conventional banking, central banks, control interest rates and money supply and act as lender of last resort. Investments and saving accounts in Islamic banks do not match with the legal definition of deposits in conventional banking terminology. This is the main reason why Islamic retail banking is not entertained in countries such as the U.K and the U.S.A. Islamic banking finance is controlled by specific mandates such impermissibility of rate of interest payment. Depositors of investment accounts whether such accounts are restricted or unrestricted must share in the losses arising out of the transactions in which the deposited amounts are used. On the other hand, they are entitled to reap their share of the profits obtained.

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<sup>1</sup> Cf. Hayes, Samuel L. & Vogel, Frank E.; "Islamic Law & Finance: Religion, Risk and Return"[ Archid & Islamic law Studies, VOL.16 Kluwer Law International 1998], see also Janahi, A.L.;" Islamic Banking, Concept, Practice & Future [ 1995 2<sup>nd</sup> edition -Manama -Bahrain Islamic Bank] see generally Wilson, Rodney.;" Islamic Financial Markets"[ London U.K -Routeledge 1990] see generally, " Islamic Banking" Special Double Issue of the Thunderbird International Review Business [ July-September Vol. 41, 1999] see generally Abdul Gafoor, A.L.M; Interest Free Commercial Banking [ Apptec Publications 1995] see also generally Khan, M.S, " Islamic interest-free banking: A theoretical analysis [ IMP staff papers, Vol. 33, No.1-1986]

Again, this is the reason why the said accounts are called risk-sharing deposit accounts.

The concept of sharing in profits and losses derives from the Shariah precept that money can not generate money. Money is considered as a mere medium of exchange. It has no intrinsic value in itself. Money could only generate money if employed in a productive venture. Such a concept is an incarnation of the fundamental Islamic principle of finance that capital providers and user of that capital had to share a faire distribution of risks and rewards. Contracts surrounded by risk and uncertainty are void. Speculations are impermissible such as derivatives embracing, inter alia, options, buying and selling future contracts, and interest rate swap.

Islamic banks differ from conventional banks in the method of financing documentary credits. They do not act on all the rules regulating documentary credits provided for in the Uniform Customs and Practice for Documentary Credits revision 1993 such as discounting drafts drawn under a negotiation credit as the practice in the commercial bills market, likewise, they do not deal in acceptance credits, overdraft facilities and forward exchange covers. Similarly, they do not charge fees for confirmations of credits. The reason behind this is that, Islamic banks keep away from transactions involving *riba* i.e. interest and *gharar* i.e. risk or uncertainty.

In practice, however, Islamic banks finance documentary credits by a short term finance instrument called *al-Murabaha* i.e. Cost plus profit contract. The task of this article is to provide a conceptual clarification of Islamic Shari'a precepts which explain why Islamic banks' finance system differs from conventional banks. Inasmuch as these theoretical

clarifications clear away confusion, they may have some indirect practical benefit.<sup>2</sup>

Part I examines the question: What is Islamic banking? This part argues that realization of the main rudiments of the Islamic doctrine is the key to understanding the Institutional and substantive principles which underlie the Islamic banking industry. Part II discusses the main rudiments of the Islamic doctrine. Under this part activities prohibited at Islamic Shari'a such as riba, gharar and hoarding are briefly dealt with. My goal in discussing the theories of riba and gharar is not solely descriptive but also analytic. In this article phrases Islamic Shari'a and Islamic Law are interchangeably used. The word jurists refer to ancient Islamic jurists. Islamic scholars well-versed in Islamic jurisprudence and economics are occupied in unflinching pursuits of structuring and promoting new financial instruments. They are concerned of devising creative solutions that address the financial problems within the purview of Islamic Shariah; however, it does appear at present that there are satisfactory solutions down the road. I respectfully think that new financial instruments are highly required.

## **II. What is Islamic Banking?**

There is no formally accepted definition of an Islamic bank, and it is probably true to say that it is quite difficult to define what an Islamic bank is. It is rather misleading to understand Islamic banking and finance as just an alternative system to interest-based conventional banking. It would be more in keeping with

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<sup>2</sup> *In Islamic Shari'ah the norm is that everything is permissible unless there is a clear text in Quran or Sunna which says otherwise. Legal doctrine should be brought to conform with actual practice, as far as no textual injunction at Islamic Shari'ah will be violated. The fact that Islamic law is meticulously religious does not imply that it is oblivious to addressing people's needs. Under the pretext of Istihsan i.e. juristic preference, modern Islamic scholars are urged to adopt the law to current reality without encroachment on precepts as prescribed in Quran and Sunna.*

reality to say that avoidance of dealings in interest-based loans constitutes one of the main reasons behind the idea of Islamic banking. This, however, does not suggest that an Islamic bank acts as a charity institution. Yet, it is true to say that as a substitute for interest-based loan contracts, Islamic banks have revitalized contractual forms which had been utilized in the Islamic medieval era, such as the Commenda, partnership contracts, leasing and Salam<sup>3</sup>. The ultimate goal of an Islamic bank is to invest monies in productive transactions, on the basis of proportional participation in profits and losses. This, however, does not dispose of the matter. The crucial point to understanding Islamic banking and finance is to say that an Islamic bank, or financial institution, is the one which derives its basic concepts, aims, theoretical and practical structure from the Islamic faith. In other words, it derives its existence from the Islamic ideology. This ideology constitutes the intellectual structure by virtue of which the Islamic bank should be guided. This in turn, implies that the Islamic system of economy is the system on the basis of which a complete theory of Islamic banking should be structured. It also entails that the Islamic legal system, is the system which governs the legality of the Islamic banking operations. It also pre-supposes that the behavioral setting derived from the Islamic teachings should be observed in every day practice, and be embodied in an earthly form.

Islamic banks are part and parcel of the Islamic doctrine which is both an intellectual system; and a way of life. It is submitted that the Islamic doctrine is characterized by being comprehensive, in the sense, that all features of Islam such as devotions, social,

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<sup>3</sup> *An arrangement by virtue of which a seller effects advanced payment for further delivery of an agricultural commodity.*

economics, politics and law etc. are interwoven together.

An attempt was made to define an Islamic bank as "a financial institution geared to collecting monies to be utilized within the purview of Islamic Shari'a, in a manner conducive to set-up a cooperative community; achieve a just distribution of wealth, and place capital in the right Islamic path."<sup>4</sup> It would be appropriate to say, that the word bank and banking in the conventional idiomatic sense, does not explain the Islamic counterpart of a bank. The Islamic parallel of a bank embraces a wide spectrum of activities which range beyond banking into a direct engagement in investment, development, and mercantile ventures. For this reason, *inter alia*, "the Bank of England has taken the position that a bank in England is an institution that accepts deposits and guarantees a stated return on those deposits, an Islamic banking institution cannot by definition be a bank in England, and therefore the bank of England sees all Islamic financing as outside its jurisdiction."<sup>5</sup>

The same position holds in the United States of America. The alternative way for an Islamic bank to do business in England, or the United States, is to avoid the name bank, and be set-up as a corporation, an investment company or any other legal form which does not implicate banking business. However, this regulatory issue peculiar to conventional banking has not, in any manner, hampered the extension of the Islamic banking industry in Europe, and other parts of the world.<sup>6</sup>

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<sup>4</sup> Cf. "The scientific and practical encyclopedia for Islamic banks" Vol. 3 (1980) at p. 84

<sup>5</sup> Cf. Terrence L. Carlson, "legal issues and negotiations" { *Islamic banking and finance*, edited by Butterworth's editorial staff 1986 at p. 71, see also David A. Suratgar "the impact of Islamic banking on world financial and commercial relations" Vol. 16 law and policy in int'l buss.1089 {1984} at p.1090

<sup>6</sup> Cf. Charles Schotta "Islamic banking in U.S, current regulatory issues" *Mid. ES.EX R*, January 1987 at p.8

One of the main shortcomings as to understanding the Islamic banking industry is lack of a complete theory as to Islamic economics. With the advent of the Islamic banking industry, Islamic economics has shown up as a new discipline. It is anticipated that Muslim scholars in economics, and Islamic jurisprudence would expound a complete framework for a coherent economics theory to be applied in the Islamic community; capable to exert itself through a process of persuasion in other communities.

As a starting point to achieving this goal, Kingdom of Saudi Arabia had called for the first International Conference of Islamic Economics which was held in February 21, 1976 at King Abdul Aziz University in Jeddah. One of the recommendations urged that due attention should be paid for an extensive research in the field, by universities in the Islamic world.

Crown Prince Mohammed Al-Faisal, head of the International Union for Islamic Banks has noted the challenge which faces Islamic banks in this respect by saying "it could be said that the great challenge which faces the pioneers in the economic domain, is the need for an innovation of an operational mechanism for the Islamic banking devices, through which the theoretical concepts of the distinguished Islamic system can be incarnated into practice."<sup>7</sup> However, the task of restructuring new financial devices to cater for the present needs is a task spotted all along its course with doubts as to legality at the Shari'a.

Modern economists view economics as an abstract empirical science which has nothing to do with divine religion. Accordingly, a dividing line has been placed between positive and normative economics. Positive economics is deemed to be the scientific

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<sup>7</sup> Cf *Is. B.J. Issue No.1 at p.10*

approach; a product of the present advancement which has nullified antecedent intellectual methodologies.

On the other hand, Islamic economists view the modern scientific economics patterns as a materialistic science devoid of the spiritual ingredient<sup>8</sup> In the words of Dr. Volker Nienhauss "the question that was for a long time beyond the scope of Western mainstream economics, outside the Marxist tradition, is whether self-interested, profit-orientated behavior could be justified from a normative or ethical point of view. This question evidently neglected in the West, is of crucial importance for the Muslim social scientist, who often criticize egotistic and materialistic behavior and instead pronounces social responsibility or a kind of altruism as the norm for individual behavior, emphasizing immaterial religious value."<sup>9</sup>

This Article maintains that one of the factors contributing to a distorted understanding of Islamic banking, and finance is the great gap between the economic ideals portrayed by the Islamic doctrine, and the practical reality of the Islamic world. This aspect represents a challenge to Islamic banks. A challenge which does not relate to denial of God, but it relates to the indifference as to the application of the true spirit of Islam. Many Muslims are unfamiliar with the true nature of the Islamic faith. Islamic banks need to embark on a continuous revitalization as to the meaning of Islamic banking to enable members of the Islamic community to be brought to concur in one Islamic thought, and one way of life, which is undoubtedly a very difficult task.

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<sup>8</sup> Cf. Al-Fanghari, MS " the economic system of Islam ( Aukaz publications-Jeddah, 1st ed. 1980, see generally Nagar.A " Introduction to economic theory in the Islamic system" {Dar al -Fikir Publications -Beirut , 2<sup>nd</sup> ed. 1974

<sup>9</sup> Cf. Dr. A. Volker Niehaus " Islamic banks and finance" edited by Butterworth's editorial staff 1986 at p.2

One commentator rightly observed that "Islamic economics offers so far, disregarding the critique of Western economics and economies, no theories about the empirical world, but only models of ideal, sometimes even utopian worlds, which do not help us understand realities in Muslim countries and which also do not explain how a transformation from the present day egoism and materialism to the altruistic and value-oriented behavior could be managed. These general reservations shall not be exemplified with respect to the contribution of Islamic economics in the field of Islamic banking and finance."<sup>10</sup> The definition of an Islamic bank as a bank which conducts its operations in accordance with Islamic Shari'a precepts brings into prominence, the importance of responding to the begging question: What are these precepts relevant to the Islamic banking industry? I am of the opinion that the key to understanding the essence of Islamic banking and finance depends on perceiving the main rudiments of the Islamic doctrine relevant to the Islamic banking industry. In the section below this somewhat difficult subject will be discussed.

### **III. The main rudiments of the Islamic Doctrine**

At the outset, I should reiterate that delineation of the main fundamentals that characterize the Islamic doctrine, fairly explains why Islamic financial institutions differently treat some conventional financial devices and practices such as deposits, accounts, letters of credit, bank guarantees, discounting of bills of exchange, foreign exchange dealings and the overdraft facility.<sup>11</sup> These basic principles permeate the whole Islamic economics and

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<sup>10</sup> *Ibid* at 3

<sup>11</sup> *In an Islamic system the rate of return is calculated in a different manner. The rate of return is determined by reference to the rate of return to the real sector of the economy. Such sector serves as a benchmark.*

jurisprudence. The first principle is the integration between immutability and evolution. The second principle is the fitting together between material interests and spiritual needs. The third principle is the equilibrium between private and public interests.

**(a) The integration between im mutability and evolution**

Most of the provisions of the Quran and the Sunna deal with faith, devotions and morality. These are immutable; they are not susceptible to change, or modification. However, in matters of business transactions ("mulamalat"), politics, economics, etc. Islamic Shari'a has only a few broad general principles, flexible enough to address changing circumstances. One can cite few examples, such as the broad general principle which states that any difficulty should be removed, unless such removal contravenes a textual injunction. Another general principle states that public interest should be observed. A third general principle states that justice should be achieved.

How to put these general principles into practice is a question on which different applications may be considered, as the circumstances may dictate, in terms of place and time. In politics for example, the general principle is that, political affairs should be conducted by mutual consultation, yet no particular form was recommended. Accordingly, each community can choose the form of consultation that best suits the needs of that community. Application of these general principles is let to "ijitihad", *i.e.* a deductive process, whether on individual basis, or jointly in any place, and for any era of time. For example, the general principle in Islam is that, a margin of adequacy should be maintained as a standard of living for each individual. A margin of adequacy cannot be

fixed as it differs from one place to another and from one period to another. Again, each community may choose the margin of adequacy which reflects the real situation in that community.<sup>12</sup>

Islamic jurists acknowledge that "precepts are changeable as periods, and places change." This has been reflected in many maxims to this effect such as "this is a period and place disagreement; and not an argument", or "this is a disagreement as to diversity and not a contradictory disagreement."<sup>13</sup> The process of "ijitihad" is governed by these broad general principles. The role of the researcher in Islamic doctrine is to seek application within the general framework of rules rather than initiation of a new rule. This does not mean that Islam places restraint on the mind, hindering its intellectual process, because "ijitihad" itself is an intellectual process; an outcome of an individual or collective opinion as to a particular issue not directly provided for by the Quran or Sunna.

The extent of Islamic Shari'a application depends on the magnitude of "ijitihad" as to any epoch or locality. There is no formal method obligatory to every Islamic community. On the contrary, Islam encourages diversification of practices within the framework of its basic principles. The criterion, whether a practice is Islamic or non-Islamic would be judged by the extent to which it abides by the basic Islamic principles. This is the reason why "ijitihad" is regarded as the third source of the Islamic jurisprudence.

However, since the end of the fourth century of the Hegira, (Muslim calendar) Muslims have dissociated themselves with Islamic studies. Consequently, Islamic

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<sup>12</sup> Cf. Al-Fanghari, *op cit. supra* note 8

<sup>13</sup> *Ibid* at p34

studies and applications were frozen at a particular historical epoch. The Islamic principles were renounced; Jurists abandoned reliance on the basic legislative sources to extract the suitable precepts. Instead, they preferred resorting to previous treatises to obligate people on the basis of these opinions. Yet, they failed to observe that these precepts were formulated to adapt to a particular epoch.

By relinquishing "ijitihad", Islam and its practices are confined to a very limited area, namely devotions and personal affairs. This attitude was the main attribute for Muslims' delay compared to Islamic jurisprudence forerunners. Opponents of Islam took the opportunity to allege that Islam stands as a stumbling block against modernization and advancement. Even some Muslim intellectuals entertained doubts as to the suitability of the Islamic doctrine. Again, the blocking of "ijitihad" caused a split in thought between religious ulemah, *i.e.* jurists, and intellectuals versed in new disciplines.

Many of the modern commercial transactions may be adopted under the rubric of public interest, as long as; these transactions do not directly clash with one of the provisions of the Holy Quran or the prophetic Sunna. Public interest plays an important role in the legislative process. The Islamic jurisprudence has a maxim which says "whenever public interest is traceable that is the direction of the law-giver."

There is latitude of flexibility in the application of business forms that serve the peoples' interest. However, most of the present Islamic banks, instead of working out new forms, attempt to admit new forms under one of the forms known to medieval jurists. In effect, as noted by one commentator, "the Islamic Shari'a is no longer the framework of the working of these banks. The juristical heritage, and the opinion

of the ancient ulemahs of legislation, has come to govern the whole position and we have fallen into a framework of unquestioning adoption because we are unable or afraid to use our discretion. The pivotal issue has come to be the pursuit of usury and its various forms to arrive at banning it, instead of pursuing economic interests and people's interest in investing their funds, developing their community and exchanging their services and condoning every form of transaction which leads to all this." <sup>14</sup>

**(b) The combination between the materialistic and the Spiritual needs**

The combination between the materialistic and the spiritual needs is premised on the Islamic belief that the substratum of the Islamic creed is God, to whom be ascribed all perfection and Majesty. Consequently, fear of God, and aspiration to please Him by observing His directions, is the determining factor in shaping the relationship between members of the community. The subtle point is that, Islam does not demarcate between what is materialistic; and what is spiritual. Nor does it differentiate between what is mundane; and what is otherworldly. In that case, any human activity whether spiritual or mundane, as far as it is permissible, is a practice of piety.

The Islamic conception is that any human activity is observed by God. This implies that besides the control prescribed by law as regards any human economic activity; there exists within the Muslim individual another intrinsic self-control having its backbone the Islamic faith and fear of the hereafter. This intrinsic self-control warrants a proper social conduct, and

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<sup>14</sup> Cf. A.kamal Abdul Magd" *the application of the Islamic Sharia: the true status of the question*" at p.37 *proceedings of International Bar Association, first regional conference, Cairo 5-9 Feb. 1987* published by Graham and Trotman, under the title " Arab comparative and commercial law the international approach Vol. "the sharia and its relevance to modern transactions"

hence a legal economic activity. Accordingly, the pious individual is expected to perceive that if he succeeded in avoiding legal sanctions, undoubtedly he would not be able to avoid God's surveillance. This type of responsibility was indicated by many prophetic traditions about faith. Prophet Mohammed, peace be upon him, said "When your good deed pleases you and your evil deed grieves you, you are a believer!"<sup>15</sup> He also said "Worship God as if you are seeing Him. If you are not seeing Him, He is seeing you."<sup>16</sup> A more quaint illustration is another prophetic tradition which says "The devil is like a wolf to man, like the wolf which harries sheep, catching the one which is solitary, the one which stays far from the folk, and the one which wanders. So avoid the branching paths and keep to the general community."<sup>17</sup>

In effect, the religious restraint is taken to be a prime factor in molding the direction of human activity. The Muslim is anticipated to automatically abide by the Islamic faith motivated by a pious sense to do righteous acts, voluntarily, out of his own volition and desire, without the need for legal sanctions. The Islamic doctrine takes the position that human activity should strive for a grand target. Though human activity is directed to achieve materialistic benefits, still, these benefits should not be aimed at for their intrinsic values. On principle, human activity should seek contribution to the well being for all humanity.

In support of this position the Quranic verse commands: "Ye people, eat of what is on earth, lawful and good, and do not follow the footsteps of the evil

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<sup>15</sup> Cf. Ibn Hanbal, *Ahamed*, "Musnad" 6 Vols. Cairo 1313H, See also AL-Buhari, "Sahih" 4 Vols. Cairo 11316H, see also Abu Dawaud, "Sunan" Cairo 1348 H

<sup>16</sup> Cf. Al-Tirmithi, "Sunan" 7 Vol. Cairo 1931

<sup>17</sup> *ibid*

one, for he is to you an avowed enemy."<sup>18</sup> Another illustrative Quranic verse commands: "But seek with the (wealth) which God has bestowed on thee the home of the hereafter, nor forget thy portion in this world, but do thou good, as God has been good to thee, and seek not (occasions) for mischief in the land, for God loves not those who do mischief".<sup>19</sup>

**(c) The equilibrium between private and public interests**

The aim of this principle is to achieve equilibrium between individual's interest and community's interest. Islam takes the position that each interest is complementary to the other. However, whenever a conflict arises between an individual interest and a community interest to an extent that a compromise between the two interests becomes difficult to attain, then the community's interest shall prevail over the individual's interest. This on principle should take place for a temporary period, whenever exceptional circumstances occur such as war or famine.

Accordingly, the Islamic doctrine has a distinguished position as to ownership. It does not agree with the capitalist system that private ownership is the norm and public ownership is the exception. Nor does it agree with the socialist system that public ownership is the norm and private ownership is the exception. The Islamic doctrine treats both ownerships on the same footing; it recognizes both private and public ownership. Yet, it prescribes for each type of ownership its boundary, not on exceptional or temporary basis dictated by a particular exigency, or circumstances. Neither public nor private ownership is absolute. Hence, Islam imposes restrictions on both types of ownership for the benefit of the whole

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<sup>18</sup> Cf. chapter 2, *Bagara* i.e. *The Heifer* verse 168 " the Holy Quran translation by Ali, A.Yusuf ( The Quran Publication-Beirut )

<sup>19</sup> Cf. chapter 28, *Qasas* or *Naration*

community to a degree that ownership fulfils a social function. The restrictions imposed by Islam on ownership are premised on the Islamic conception of ownership. Islam considers that the owner of all property on earth is God. The evidence as to this position could easily be traced in a number of Quranic verses. In one verse God, the Almighty says "For to Him belongeth the domain of the heavens, and the earth, and all that is between, He createth what He pleaseth for God has power over all things."<sup>20</sup> Another verse in the same vein says "To God doth belong the domain of the heavens and earth, and all that is therein, and it is He who has power over all things."<sup>21</sup> Another verse reiterates the same meaning as thus: "To Him belongs what is in the heavens and on earth and all between them, and all beneath the soil".<sup>22</sup>

The logical inference to be drawn from these verses is that if all property on earth belongs to God, then human beings are just representatives of God on earth. Some Quranic verses support this Islamic conception. In Verse 17 of Chapter 2, *i.e.* Surrat Al Baqara or the Heifer, God says: "Behold, thy Lord said to the angels: "I will create a viceregent on earth". Again, in Chapter 57 Surrat Hadid or iron, the verse commands: "Believe in God and His Apostle and spend (in charity) out of the (substance) whereof He has made you heirs. For those of you who believe and spend (in charity), for them is a great reward".<sup>23</sup>

Nevertheless, Islam realizes that the human being possesses by nature a motive towards ownership. This instinct is recognized in Quran and Sunna, *i.e.* the prophetic tradition. In Verses 19 and 20 of Chapter 89, Fajr or the Break of Day, God says: "And ye devour

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<sup>20</sup> Cf. chapter 5, *Maida* or the table spread, verse 17

<sup>21</sup> *Ibid* verse 120

<sup>22</sup> Cf. chapter xx, *Taha*, verse 6

<sup>23</sup> Translation of Ali A. Yusuf.

inheritance. All with greed. And ye, love wealth with inordinate love." The prophet, peace be upon him, was reported to have said "If the human being has two valleys full of money he would have demanded a third."<sup>24</sup> However, Islam imposes restrictions on private ownership to avoid two injurious risks. One is the accumulation of wealth on the premise that accumulation of wealth is prone to create a sense of ascendancy and despotism which eventually leads to monopoly. The other is the risk of poverty and its physical and psychological effects.

Under the Islamic doctrine the government may intervene to achieve equilibrium in the economic set-up. To this end, it may appropriate private property for public interest purposes. No general rule was established as to government intervention. The state on the ground of public interest may enlarge or lessen its intervention. However, the state's main task of intervention focuses on curbing hoarding and undertaking activities dodged by individuals such as heavy industries, land reclamation, establishment of schools and hospitals etc.

The state undertakes such activities under the rubric of collective duties. Under this precept, the state is accountable to secure for any individual a reasonable standard of living in the event of poverty, illness or old age. The main Islamic tax is called Zakat.<sup>25</sup> From the Zakat proceeds the state accommodates

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<sup>24</sup> Muslim Ibn Hajjag, "Sahih" 9 Vol. Cairo 1349

<sup>25</sup> Zakat i.e. alms tax is the main tax at the Islamic system. Verse 60 of chapter ix Tauba. I.e. repentance or Barat ordains where Zakat should be expended. It commands that "Alms are for the poor and the needy, and those employed to administer the funds, for those whose hearts have been recently reconciled to truth, for those in bondage and in debt, in the cause of God, and God is full of knowledge and wisdom". Only four categories of property are subject to Zakat i.e. Cattles, Crops and fruits, gold, silver and merchandize. It consists of four rates. First, twenty percent or one fifth, second, ten percent or one tenth, third, five percent or one-twentieth, fourth, two and a half percent or one-fortieth. The rate of zakat is commensurate to the volume of labour involved. In the case of rainfall irrigation, the rate of zakat for crops is one tenth, however in the case of man-made irrigation it is one-twentieth. In activities involving continuous labor such as trade it is one fortieth; however, when no labor is involved such as discovering a treasure-trove, it is one fifth.

each needy individual with a suitable standard of living termed by jurists as the margin of adequacy in contrast to the margin of subsistence. Zakat is a manifestation of social joint solidarity. It is the main device to achieve social co-operation. It was also ordained in the Quran and the prophetic tradition that, the state may impose taxes beyond the proportions prescribed as Zakat. Islamic banks unlike conventional banks should pay annually the prescribed proportion of Zakat.

Islam on principle considers any economic activity as permissible unless there is a "nuss", *i.e.* provision restricting or prohibiting a particular activity. The underlying consideration in banning particular activities or devices is to remove factors which lead to upsetting equilibrium in the economic set-up of the community. Moreover, Islam shows a clear opposition to risk and unjustified enrichment. This is the reason why Islamic banks are prohibited from dealing in activities involving "riba", "gharar" (risk), speculation, gambling, and hoarding. It would be in order to briefly provide an analysis as to the theories of riba, gharar, and hoarding.

**(1) Riba (Interest)**

The impermissibility of "riba" (interest) at Islamic Shari'a on monies lent is ordained by the Quran, Sunna, *i.e.* the prophetic tradition and unanimity of the masses of ancient jurists. One learned companion of Prophet Mohammed (peace be upon him) was reported to have said "He who lends should not stipulate more than what he has lent, even a handful of fodder; for it is riba."<sup>26</sup> Pious Muslims take the most elaborate precautions to avoid transactions that involve "riba".

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<sup>26</sup> *Ibn Rushd, Mugadimat, Cairo-Saada Publications, 1325H Vol. 3 at p.149, the companions referred to was Abullah Ibn Omer.*

In the words of Joseph Schacht "They were always conscious that a direct breach of the prohibition of riba (interest) was a deadly sin".<sup>27</sup>

Riba has been one of the most difficult legal issues in the Islamic jurisprudence. It has attracted an extensive debate among ancient Islamic jurists and modern scholars, as to the true interpretation and analysis of the textual provisions in the Quran and Sunna. Omar Ibn Al-Khatab, the third orthodox caliph *i.e.* successor to the prophet Mohammed (peace be upon him) was reported to have said: "By God, we perhaps unknowingly, ask you to do things which do not suit you, and perhaps we enjoin you from doing things that suit you. The last Quran revealed to the prophet were the riba verses, and the prophet died before explaining it to us. Leave what you doubt for that which you do not doubt".<sup>28</sup>

Riba (interest) is of two kinds: One is called "Riba'l Fadl" or sales riba. It was termed by the ancient Islamic jurist, Ibn Al Qayyum as "riba'l kaffi", *i.e.* invisible riba". The word "fadl" is Arabic word which means surplus or excess. It is only confined to commodities such as foodstuffs and precious metals. The other type of riba is called "riba'l nasiah" or debts riba. It was termed by Ibn Al Qayyum as "riba'l jali", *i.e.* plain riba. The word "nasiah" is an Arabic word which means delay. It can be defined as a stipulated increase on capital in consideration for a respite of time. It is mainly associated with loan contracts or debts; it is interest proper; the focus of Islamic Shari'a's abhorrence.

Riba'l Fadl can be defined as an exchange of alikes with a stipulated increase as to one of them; or

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<sup>27</sup> Schacht J. "Riba" { *Encyclopedia of Islam Vol.3, Leyden, E.J Brill ltd, London, Lusac and Co.* } at p. 1150

<sup>28</sup> Cf. Sanhoury, Abul Raziq "sources of right in Islamic Jurisprudence Vol.3 at p201 (Dar AL-Fikir publications IST Ed.

an increase in one of two similar considerations without an offset as to such an increase. For example, a trader sells 10 sacks of good quality wheat in exchange for 12 sacks of bad quality wheat. The consideration for parting with the good quality wheat is the two sacks over and above the ten sacks of good quality wheat. In another situation, the wheat to be exchanged may be of the same quality, however, the increase of the two sacks is stipulated in consideration for late delivery.

This signifies that differences as to quality or time of delivery cannot be taken as an excuse for an increase in the quantity of one of the two commodities subject of exchange. Thus, a stipulation of an extra quantity in exchange of the same cognate merchandise of the same quantity is impermissible at Islamic Shari'a. Moreover, physical delivery should take place once the contract is concluded.

Riba'l Fadl derives its source from the prophetic tradition which says "Gold for Gold, silver for silver, wheat for wheat, barley for barley date for date and salt for salt, be exchanged the same thing for the same thing, in equal quantity and hand to hand. One who demanded extra or paid extra has indulged in interest".<sup>29</sup> The prophetic tradition further goes "when these kinds differ, then sell them as you like (with the difference of quantity provided that it was hand to hand)".<sup>30</sup> The point to be observed is that, at Islamic Shari'a, in any commutative contract; the contributions of one party to the contract should be in equipoise as to the contributions of the other party. The object is to maintain equivalence ("tamaathol") in sale contracts. This is a fundamental Islamic Shari'a

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<sup>29</sup> *Muslim Sahih Vol.2 Cairo at p.44*

<sup>30</sup> *ibid*

precept which pervades the entire Islamic law of obligations.

It is suggested that the philosophy behind prohibition of "riba'l fadl" is to block the possibility of engaging a deferred exchange in consideration for a stipulated increase. Also to remove uncertainty as to a proper assessment of the difference in quality. Again, if interest dealings were allowed in foodstuffs this would tend to eliminate their proper function as a diet ("mutumat"). Similarly, if interest dealings were allowed in gold and silver, their main purpose as a measure of value ("thamaniyah") would be discarded. However, if the exchanged merchandise were different as to kind the only prescribed restriction is that, delivery should be made at the time the contract is to be concluded. This includes dealings in silver and gold ornaments in exchange for gold and silver bullion, irrespective of a difference as to weight. The rationale is that gold and silver after being transformed into ornaments will be reduced to the category of commodities.<sup>31</sup> There is no question of interest as regards a transaction for the sale of goods in exchange for a price. This would fall within the ambit of "musa'wama" contract, *i.e.* the sale of goods at any price agreed upon between the contracting parties.

It is important to note that riba'l fadl is not as serious as "riba'l nasiah" which is considered to be the focus of prohibition as the plain, proper riba. "Riba'l fadl" is prohibited on the ground of what is termed at Islamic Shari'a, "Sadd al Dhari'ah, *i.e.* preventive measures. In other words, if transactions involving "riba'l fadl" are allowed, they might be utilized to achieve proper riba, and its corollary unjustified enrichment. Thus, "riba'l nasiah" is

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<sup>31</sup> *Ibn al-Qayyim "I'lam al-Muwakiheen" vol. 2 Cairo at pp10-108*

prohibited *per se* as to ends, and "riba'l fadl" is prohibited *qua means*.<sup>32</sup>

It is submitted that "riba'l nasiah" is impermissible unless there exists an exigency, an indispensable necessity. However, necessity at the Islamic Shari'a can only be invoked in very extraordinary circumstances such as those which force an individual to eat dead meat or blood. In other words, necessity for an individual is that of "being on the verge of exhaustion; for a state the necessity to procure bread and arms".<sup>33</sup> On the other hand "riba'l fadl" is permissible in situations of need as dictated by Al Maslah Al Ammah, *ie.* public interest. In any way, a need to pass the public interest test must qualify as a public and not a particular interest. Second, it must be actual and not a sham. Third, legislation must be promulgated to this effect, provided that it shall not contravene a textual Islamic Shari'a injunction, or contradict a rule established by unanimity of jurists.<sup>34</sup>

Medieval Islamic jurists have not contested the impermissibility of riba as it is expressly ordained by the Quran and Sunna. Nonetheless, the issue which remained subject of past and present dispute is the exact bounds of riba. The issue on this point is, whether riba is confined to sales riba or does it extend to cover debts riba? Quran has mentioned riba in eight verses which appear in four different chapters.

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<sup>32</sup> *Ibid* at 100-103, see also *ibn Rushd*, "Bedi'at al-Mugtahid" Cairo-Saada Publications, 1347 H Vol 2 at p116-119

<sup>33</sup> Cf. *Ibn Nageem*, "Al-Ashbah Wa'l Nathair (Cairo-Dar-al-Tiba, 1290H) Vol, 1 at p.125, see also *Ibn Qudama Al-Mughni* (Beirut- Dar-al Kitab-al -Arabi, 1392H) Vol. 8 at p601, see also *Ibn Hazm* "Al-Muhala-Cairo Vol. 8 at 381, see also *AL-Kassani*, "AL-Badi'ah (Cairo-Jamaliah publications 1327H vol, 5 at p129, see also *Shirbini AL-Khateeb*" *Mughni Al-Muhtag-Cairo* (Halabi Publications, 1377Hvol4 at p307, see also *Ibn Jazzi*, "Kawaneen at-Fihhiyah-Beirut at p.173, see also *Al-Izz Ibn Adal -Salam*" *Quwai'id al-Ahkam Fi-Massalih al-Anam*" Cairo Vol. 1 at p8, see also *Ibn Arabi*" *Ahkam al-Quran*" Cairo vol 4 atpp58, 146

<sup>34</sup> Cf. *Kilaf, Abdu Wahab*" *Asul al-Fikh*" at p.86 (Dar al Kalam Publications 9<sup>th</sup> ed.1970) see also *Shaltout, Mohamed*, "Fatwa" Cairo at pp.350-355

According to the sequence of revelation, the first revealed verse is contained in Chapter Thirty, the Rum, *i.e.* the Roman Empire.<sup>35</sup> The second revealed verse is contained in Chapter Four, Nisa'a,<sup>36</sup> *i.e.* the women. The third revealed verse is contained in Chapter Three Al-i-Imran,<sup>37</sup> *i.e.* the family of Imran. The last revealed five verses are contained in Chapter Two, Baqara, *i.e.* the Heifer.<sup>38</sup> The tenor of the first revealed two verses suggests that banning of riba was not ordained directly but by insinuation. The tenor of the third revealed verse assumes a much more direct language. It implies a reprimand for those who used to stipulate multiple riba. It reads as follows: "Ye who believe devour not usury, doubled and multiplied, but fear God that 'ye may (really) prosper".

In Chapter Two, Baqara, an express banning of riba in the most emphatic, severe language can be discerned. Verse 275 of the said Chapter reads as follows: "Those who devour usury will not stand except as stands one whom the evil one by his touch has driven to madness. That is because they say "trade is like usury", but God has permitted trade and forbidden usury". In Verse 278 of Baqara, God commands as follows: "Ye who believe! Fear God, and give up what remains of your demand for usury, if you are indeed believers". Verse 279 ordains that the creditor should only demand his capital "If ye do it not, take notice of war from God and His apostle: But if you turn back, ye shall have your capital sum: Deal not unjustly, and ye shall not be dealt with unjustly".

Ancient Islamic jurists were divided into two lines of thought. One line of thought represented by the Hanifi school of thought, has taken the view that

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<sup>35</sup> Verse 39

<sup>36</sup> Verse 161

<sup>37</sup> Verse 130

<sup>38</sup> Verses 275, 276, 278, 279

the literal meaning of riba, as mentioned in the Quran, indicates a general rather than a particular prohibition. They have contended that the verses dealing with riba are in a generalized tenor, whereby, the purport is not clearly understood. They have argued that riba means an increase, and this does not necessarily signify that any increase is impermissible.

In an effort to explain the generalized language contained in the Quran, as to the banning of riba, these jurists considered it incumbent upon them to resort to the earlier mentioned prophetic tradition which deals with sales riba. They came to the conclusion that, the prophetic tradition explained riba in the context of sales transactions, and not debts transactions.

Accordingly, this category of ancient Islamic jurists has taken the opinion that interest bearing loans are not the principal source for the prohibition of riba. It has also declined to accept, as a ground for the prohibition of debts riba, the prophetic tradition which say, "Any loan which gives rise to a benefit is riba".<sup>39</sup> Jurists of this category have argued that a loan stipulating a benefit does not fall within the purview of the riba ordained in the Quran. Anyhow, they have denied that an interest bearing loan is textually banned as riba. They have also argued that a loan contract is not a commutative contract, and riba deals with commutative contracts. On this account, these jurists have expressed the opinion that debt riba is prohibited by way of analogy. In view of this position, they have defined riba as a stipulated increase in a sale without an offset as to such an increase.<sup>40</sup>

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<sup>39</sup> Cf. *An-Nassai, Sunan 7 Vols, Cairo*

<sup>40</sup> Cf. *Ibn Rushid. Mugadimat-Cairo-Saada Publications, 1325 H Vol.3 at p.149, see also Kasani, Badi'ah al-Sani'ah, Cairo vol7 at p 395, see also Nawawi" magmuh Sharah al-Muhazab Cario, vol.9 at 443*

The other category of jurists which represents the masses of ancient Islamic jurists has contended that to qualify as a riba, three ingredients must be satisfied: First, an increment on capital should materialize; second, such an increment must be stipulated; third, the increment must be stipulated in consideration for a respite of time. They have further argued that any increment on capital in connection with a sale, or a loan contract which satisfies the above mentioned three conditions is categorically riba, whatsoever the form or nomenclature. They have indicated that, pre-Islamic riba engulfed both sales and debts riba.

Pre-Islamic riba, as they have stated falls into one of two situations. One situation involves a stipulated increase at maturity date. A trader in a deferred sale transaction asks the debtor at the maturity date either to pay or allow a stipulated increase. This situation was mentioned by Al-Tabri, an eminent ancient Islamic jurist.<sup>41</sup> The other situation dealt with loan contracts, whereby a trader extends a loan to another stipulating an increase in consideration for a deferred payment. This situation was mentioned by the eminent ancient Islamic jurist Al-Jassas.<sup>42</sup> This class of jurists found it difficult to agree with the view that riba is mentioned in the Quran in a generalized language. They have argued that the word "riba" was neither new nor ambiguous to the pre-Islamic Arabs. If it were ambiguous, companions of the prophet, peace be upon him, could have asked him to explain the word. They have further argued that, if the word "riba" has gone beyond its linguistic bounds to assume a technical juristical meaning, this could

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<sup>41</sup> Cf. *AL-Tabari, Mohamed Ibn Gareer "Jam'ih al-Biayan" Vol 3 at P.101 (Dar al Marif Publications – Cairo.)*

<sup>42</sup> Cf. *Al-Jassas, Ahamed Ibn Ali al-Razi " Ahkam al-Quran" Vol.1 at p.184 ( Dar Tebaht al-Kutub Publications, Cairo) see also Shawakani " Fatah a –Gadeer" Cairo, VOL. 3 at p.265*

easily be traced with reference to the realities of the market place in the pre-Islamic epoch.

Al-Fakhr Al-Razi, a distinguished ancient jurist said "Riba'l Nasiah was the business which had been widespread and customary in the Jahiliyah, *i.e.* pre-Islamic period that they had used to give money in consideration for a monthly stipulated increase, provided that the principal amount of the loan shall remain intact. Then, when the time of repayment arrives, the debtor will be asked to pay the principal amount of the loan. Should he fail to satisfy the debt, they increase the principal amount and the term".<sup>43</sup> Al-Shatbi, another renowned ancient jurist said that "the prohibited riba by the text of the Quran is only riba the Jahiliya, but the Sunna added "riba'l fadl" by analogy.<sup>44</sup> This division of jurists has concluded that the word "riba" should be understood in the context of the state of affairs of the pre-Islamic Arabs. They have also found support in the prophetic tradition which says "any loan which gives rise to a benefit is riba".<sup>45</sup> In summary then, these jurists have itemized riba with debts.

On the basis of the Hanifi exposition, earlier noted,<sup>46</sup> modern scholars are split as to the exact bounds of riba. One group permits an interest-bearing loan, on the ground that this type of riba was not the principal source for prohibition of riba. They further argue that, riba relates to commutative contracts, unlike loan contracts. It seems to me that this view could easily be demolished by reference to the prophetic saying that "any loan which draws a benefit is riba". This view contends that a loan contract is not a commutative contract but a donation. At any

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<sup>43</sup> Cf. Al-Razai, Fakhr, "Al-Tafseer al-Kabeer" Cairo Vol.7 at p.85

<sup>44</sup> Cf. Shatibi, Abu Ishaq, "Muwafagat Fi Ausul al-Fikh" Cairo vol.4 at p41

<sup>45</sup> Cf. Al-Nasal

<sup>46</sup> Cf. Ibn Rushd.

rate, there is little, if any authority on the point that a loan at Islamic Shari'a, is just a donation contract. At Islamic Shari'a, a loan contract arises as a donation contract, but it ends as a commutative contract as the debtor is bound to repay the principal amount of the loan. The pre-Islamic Arabs considered *riba* as the price of capital. This was evidenced by the Quran that "they say (pre-Islamic Arabs) trade is like usury".<sup>47</sup>

Another group of Islamic modern scholars, though they do not concede the permissibility of interest-bearing loans, still entertain the belief that interest-bearing loans were not the principal source for the prohibition of *riba*. They argue that an interest-bearing loan is permissible in situations of need. That under the circumstances of the present capitalist economy, the entrepreneur needs capital to match it with his own labour. Hence, an interest-bearing loan is the only device by virtue of which an entrepreneur can procure capital.

This group of scholars suggests that particular checks should be observed. First, an interest should not be paid on accumulated interest; second, a limitation should be imposed on simple interest rate and the method of repayment, besides a legal control as to the whole amount of interest; third, if the capitalist system were to change, then *riba* reverts to its original nature of being prohibited.

After all, this view has not addressed the situations under which necessity may be invoked. At Islamic Shari'a as earlier noted<sup>48</sup> necessity should be invoked in highly exceptional circumstances such as those forcing a person to eat dead meat or blood. Moreover, necessity cannot be invoked where a

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<sup>47</sup> Verse 275 of Chapter 11 Al-Baqara i.e. the Heifer

<sup>48</sup> To establish necessity you need to adduce very strong evidence.

substitute can be furnished. At Islamic Shari'a loss and profit participation partnerships are the offered substitutes. Again, at Islamic Shari'a any one sided increment on capital in consideration for a respite of time is deemed to be riba.

A third group of modern Islamic scholars, subscribes to the view that riba should be confined to only usurious dealings where the rate of interest is exorbitant. They argue that pre-Islamic riba, the subject of prohibition, was doubled and multiplied riba, and as such does not apply to modern interest rates.<sup>49</sup>

It is submitted that this line of thought failed to correctly interpret the phrase "doubled and multiplied riba" in its real perspective. In the words of Al-Gortbi, a distinguished ancient Islamic jurist "the phrase doubled and multiplied is an indication as to the repetition of redoubling year after year. This phrase evidenced their repugnant and ugly acts".<sup>50</sup> Al-Shokani, another famous ancient Islamic jurist said "The phrase doubled and multiplied is not intended to particularize prohibition, as it was understood that riba is impermissible under any circumstances, but it was mentioned to indicate their customary practices in riba. The exaggeration in the phrase denotes a confirmation of reprimand".<sup>51</sup>

Even if we assume that the said phrase embodied in the Quranic verse qualifies riba to that of "doubled and multiplied", it is still difficult to reconcile it with the next verse which absolutely prohibits riba in the most sweeping language. It seems fair to suggest,

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<sup>49</sup> Cf. *Rida, Mohamed Rasheed "Riba and transactions in Islam" at pp.77, 86-94 ( Dar Ibn Zaydon Publications, Beirut, 1st edition 1986) see also Majallat al-Manar Vol.9 at p 332 (1906) see also Badawi, Ibrahim Saki al-Deen, " The theory of prohibited Riba in Islam" at p222*

<sup>50</sup> Cf. *Al-Gortubi, Abu Abdulla Mohamed bn Ahamed AL-Ansari " Jamiaah Ahkam al-Quran" vol.4 p202 ( Dar-al-Kitab Publications-Cairo)*

<sup>51</sup> Cf. *Shawkani, Mohamed bn Ali, " Fatah al-Gadeer vol.1 at p380 ( Dar al-Marifa Publications-Cairo 3<sup>rd</sup> ed)*

that the latter verse in revelation sequence should govern the disputable issue. Placed in this context, the qualified provision should be interpreted in light of the unqualified provision.

A fourth group of modern Islamic scholars, takes the view that a demarcation should be made between what are called productive loans, and consumptive loans. They argue that loans to be made for productive activities must be viewed differently in the context of present economic development, unlike the pre-Islamic circumstances. They offer as evidence that governments and big companies with a view to raising capital borrow from the public including those with small savings.

At first blush, one might be inclined to say that this is the correct view; however, the suggestion does not withhold rigorous dispassionate analysis. This category of jurists has failed to translate their position as a logical and reasoned deduction emanating from basic principles governing riba at Islamic Shari'a. Instead, they contend, on subjective reasoning, that the present changed economic circumstances necessitate a demarcation between consumptive and productive loans. But this does not dispose of the matter. The Quran has in a sweeping, unqualified language banned riba, irrespective of the type of activity involved. Quran also urged creditors, in the event of repentance to claim just the principal amount of the loan. Again, this line of thought conflicts with the prophetic tradition that prohibits any increment on a loan. Even if it is possible to identify productive projects, there is no guarantee that the borrowing entrepreneur is most probably to succeed in his project. What is the position should the project fail? Of course, the entrepreneur is bound to repay the principal amount of the loan plus interest. Here lies the difference at

Islamic Shari'a by substituting profit and loss participation partnerships for interest-bearing loan contracts. In the words of Professor William M. Ballantyne of the School of Oriental and African Studies, University of London, this different approach "makes the Shari'a really inconsistent with what modern man has made of commerce. We cannot here enter into philosophical discussion as to which theory is right, although a glance at the existing Western banking system would seem to provide an immediate argument in favour of Shari'a".<sup>52</sup>

Some modern scholars go further, and suggest that interest dealings by government banks should be allowed on the ground that, what an individual earns from a deposit represents a social benefit, and what the bank earns from a loan represents a tax.<sup>53</sup> It is obvious that this is just a subjective point of view. Rational legal reasoning at Islamic Shari'a mandates that any suggested view should be a result of a deductive process based on the theory of riba at Islamic Shari'a. Similarly, a group of modern scholars subscribes to the view that, in the present inflationary economic climate, interest stands as a compensation for the lender against inflation.<sup>54</sup> Again, this view is no more than a subjective point of view as it is not based on the theory of riba at Islamic Shari'a.

Some Egyptian scholars subscribe to the view that interest arising from deposits in Savings Funds administered by government banks and Mail Boards are

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<sup>52</sup> Cf. Professor William M. Ballantyne "The Shari'a and its relevance to modern transnational transactions" at p.10, proceedings of the International Bar Association, Cairo, 5-9 Feb, published by Graham and Trotman.

<sup>53</sup> Cf. "Reba in Islam and modern economic theories" at p.63 ( Kuwait Publications House- undated)

<sup>54</sup> Cf. S.A Amin:" Islamic banking and finance ( Tehran, Vahid Publications at p, 25, 1986 ed) see also Andrew Malineux "International banking and financial systems- a comparison ( Graham & Trotman, 175, 1987 ed)

permissible.<sup>55</sup> They contend that the Fund or the bank does not own the deposit accounts. The depositor in this situation contracts with the Fund to invest the deposit in his own name, and to this end receives an investment certificate. They also argue that saving funds reflect a wide participation of the public in commercial, industrial and investment activities. They further argue that this form of deposits falls within the ambit of a transaction rather than a loan contract. It seems to me that the better view favours the permissibility of this method of dealing in public savings, provided that these funds were to be really applied in investment projects. I can entertain no doubt that, if and only if, these funds were utilized in investment projects, then the question of riba should not arise. However, the position would be different if these funds were relouaned to commercial banks or the treasury in consideration for a pre-determined interest. In this situation, such dealing would definitely fall within the purview of riba proper.

Mjma-al-Bohoos of al-AZhar presided over by Dr. Tantawi; Sheikh al-Azhar issued a Fatwa adopted by a majority of twenty members to one member. The Fatwa prescribed that an investor who advances funds to a bank, in its capacity as an agent, to invest his or her funds in exchange for a predetermined sharing is permissible. The Fatwa contends that such a transaction is permissible, as it does not contravene a textual injunction in the Quran or Sunna. The said Fatwa maintains that the crucial aspect of the transaction is the mutual consent of the parties.

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<sup>55</sup> Cf. Shalabi, Ahamed " Islamand modern economic questions" at p55 ( Union of Publishers House-Cairo-undated)

One of the rationales underlying Dr. Tantaw's Fatwa is the state of corruption, dishonesty and greed prevailing on our times. This is a right observation, however Islamic banks are urged to apply prudential, and due diligence standards in the sense of dissecting the probity and consistency of borrowers. On the other hand, investors had to seek institutions where appropriate corporate governance standards are applied. Added to this, the Islamic moral precepts act as an intrinsic deterrent; an internal watchdog, if so to speak. Such morals should encourage a Muslim to act in a manner compatible with Islamic teachings. The manner in which Islamic banks conduct business should be in strict conformity to Islamic precepts. Such conduct may indirectly contribute to the process of educating the general populace as to the proper manner of conducting business. Islam is a holistic way of life. Morals are not a separate compartment, but an integral part of the Islamic doctrine.

Dr. Tantawi's Fatwa has spawned much controversy, however it was overturned by The Islamic Jurisprudence Council decision No. 133 issued in its 4<sup>th</sup> meeting convened on January 2003.<sup>56</sup> The Islamic Jurisprudence Council contends that Islamic shari'ah categorizes amounts deposited into conventional banks as deposits; and given the fact that a predetermined rate of return is a condition precedent, then this falls on all fours within the ambit of Riba i.e. interest. The decision clearly contends, that in such a transaction, agency can not be triggered, as the bank guarantees, the principal amount of the deposit or loan contract. It is respectfully submitted that the decision of the Islamic Jurisprudence Council is in accord with the overwhelming majority of modern scholars well-versed in Islamic Jurisprudence. Islamic banks can not accept

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<sup>56</sup> 14<sup>th</sup> meeting of Islamic Jurisprudence Council-January 2003-Decision No.133 [7/14] at pp. 20-24

loans or deposits on condition of payment of a prefixed return, but rather accept partaking in the profits that may ensue from employing the funds. Depositors, who elect to engage the services of Islamic investment institutions, must agree to share in the profits in accordance to predetermined ratios. They are entitled to profits, on the ground, of assuming risks associated with normal business transactions. On the other hand, conventional banks are essentially lenders and borrowers, in contrast to Islamic banks, which are essentially partners with their depositors.

In sum, the Islamic rule is that, money should be a measure of wealth rather than a measure of unit. In other words, money should stand for real goods, assets and services. Interest is considered to be an artificial element as it is a product of utilizing money to generate money without involving the element of labour and risk. The basic rationale behind prohibition of *riba* is to curb exploitation. Gain must be against risk and when there is no risk the reward must be zero.<sup>57</sup> It may be argued that the international monetary crises are essentially due to the institution of interest. It may also be argued that the efficiency of interest as a benchmark of saving and investment is a fallacy. On the other hand, the exploitative character of interest is manifest and it would be a process of belaboring the obvious to say otherwise.<sup>58</sup> Conventional banks are free to take on equity shareholding and run Islamic counters or windows.

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<sup>57</sup> Cf. Ibrahim Kamel" Conference report on Islamic Banking and Commercial Practice. Sep. 18, 1984 at .8 (Middle East Association Bursy House, 3Bursy Street, St.James, London) see also AL-Ashgar, Omer Suliman" *Riba and its impact on the human community*" at pp.120-122 (Manar Publications-Jordan 1988 2s ed.)

<sup>58</sup> Cf. " Keynote Address by Prime Minister (as he then was) of Malaysia Dr. Muhathir Mohamad, at the inauguration of the IFSB: Reshaping the International Financial Architecture for Balanced and Stable Growth" available at [http:// www.ifsb.org/index.php?](http://www.ifsb.org/index.php?)

## **(2)Gharar (i.e. Risk or Uncertainty**

Gharar is one of the most confused and difficult areas in Islamic law. Islamic banks keep away from dealing in some modern international business transactions on the ground of gharar such as dealing in future contracts traded in the futures market.<sup>59</sup>

Gharar literally means the state of unknowingly exposing oneself or property to risk. It is defined by ancient Islamic jurists as any act characterized by an unknown outcome, or an act a person cannot warrant whether it will materialize or not.<sup>60</sup> In other words, gharar is implicated in any action or deal which a person undertakes without knowing its aftermath.<sup>61</sup> Some examples were cited by ancient Islamic jurists as to deals involving gharar, such as selling a fish in water; or a bird in air, or an embryo of a she-camel.<sup>62</sup>

Gharar can also be invoked in a situation involving uncertainty, such as lack of knowledge as to the nature of the subject matter of contract. In this context, it was described by one ancient scholar as "anything which apparently tempts the purchaser though its intrinsic nature is unknown".<sup>63</sup> Hence gharar may address situations involving risk or uncertainty or both. Ibn Rushd, a distinguished ancient Islamic jurist, has subsumed uncertainty which leads to dispute within the ambit of gharar. He has subscribed to the view that gharar in sale contracts might be invoked in the following situations: First, in instances of uncertainty as to identification of the subject matter of contract; second, in instances of uncertainty as to

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<sup>59</sup> *A future contract deals with commodity exchange, it is an agreement to sell or buy a specific commodity, or a financial instrument at a particular price on condition that delivery shall be made on a stipulated future date. The contract contains an option clause to the effect that the option buyer may elect to carry out the transaction or decline by the option exercise date.*

<sup>60</sup> *Cf. sarkasi, Mabsout vol.12 at p194, see also Kasani, Badi'ah vol.5 at p193*

<sup>61</sup> *Cf. bin Jazzi " Quwaneen al-Fikhiyah { Dar al-Kalam-Beirut} at p.260, see also Ibn Quadama , Mughni{ Beirut-Dal-kitab al-Arabi } vol.4 at p205*

<sup>62</sup> *Cf. Sanhoury at p.49 supra note 27*

<sup>63</sup> *Cf. Al-Dareer, Siddiq" Qharar and its impact on contract" at pp28, 651,654*

determination of purchase price; third, in instances of uncertainty as to non-existence of subject matter of contract, or the ability of the seller to deliver it; fourthly, in instances as to the state of the subject of contract, whether it is defective or not.<sup>64</sup>

However, some ancient Islamic jurists have discussed gharar only under the third instance which relates to non-existence of the subject matter of sale at the time of contracting, and its corollary non-ability of the seller to deliver the subject matter of sale at the time of contracting.

The predominant view of masses of ancient Islamic jurists is that, the subject matter of contract must be present at the time of contracting. It is not sufficient that the subject matter of sale shall exist at a future date. The fact of non-existence of the subject matter of contract at the time of contracting vitiates the contract on the ground of gharar. On the other hand, it is not only sufficient that the subject matter must be present at the time of contracting, but also an immediate method of delivery must be available. Furthermore, any uncertainty relating to subject matter of contract as to kind, type, nature, quality and time of delivery vitiates the contract on the ground of gharar.<sup>65</sup>

In commutative contracts, gharar is of two kinds. One kind was termed by ancient Islamic jurists as considerable gharar; the other kind was termed as inconsiderable gharar. Considerable gharar vitiates a contract, provided that it is not dictated by necessity. In situations of necessity gharar cannot be triggered even if it were of the considerable type.<sup>66</sup>

It is pertinent to note that Islamic jurisprudence classifies commutative contracts into two kinds: One

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<sup>64</sup> Cf. Ibn Rushd, "Bidia't al-Mugtahid { Cairo -al-Stigamah publications}vol.2 at pp122-123

<sup>65</sup> Cf. Sanhuri at p.49 supra note 27

<sup>66</sup> Ibid

kind relates to financial commutative contracts which involve an exchange of property in consideration for another property such as sale contracts, and currency exchange contracts. Within this kind fall contracts which relate to benefits having an ascertainable value such as lease contracts.

The second type relates to non-financial commutative contracts such as marriage contracts, and "khalah" contracts, whereby, a man divorces his wife, in consideration for a monetary compensation to be paid by her to him. Peacemaking contracts in situations of wars also fall within the ambit of this type. These types of contracts involve an exchange of property, in consideration for something which does not qualify as a property or benefit. Though considerable gharar vitiates financial commutative contracts, it does not vitiate non-financial commutative contracts. The rationale is that, in the latter type, property is not the main purpose behind the contract.<sup>67</sup>

There is no hard and fast rule as to the criterion of considerable and inconsiderable gharar. Moreover, no criterion as to situations on which gharar may be absolved on the ground of necessity. It is submitted that as to these issues one locality may differ from the other. Also the criterion is susceptible to change from one period of time to another. Even in one locality, and in one period of time a difference may occur.<sup>68</sup> Accordingly, at the Islamic Shari'a, there is wide latitude as to assessment of the volume of gharar which shall be vitiating to any contract.

With a view to clarifying the position taken by the masses of ancient Islamic jurists, as to sale of a non-existent object, it is in order to compare their position with the English common law system. At the

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<sup>67</sup> Cf. *Ibn al-Qayyim*, at p.69

<sup>68</sup> Cf. *Sanhouri*, at p.49 *supra* note 27

English common law system, in the case of sale of a non-existent object, the contract will be vitiated on the ground of mutual mistake, if the agreement was concluded on the assumption of the existence of the subject matter of contract, which latter proved to be untrue.<sup>69</sup> The opinion of the masses of ancient Islamic jurists hold that, even if the contract is based on a true assumption of the existence of the object of sale, though it cannot be guaranteed that the subject matter will be available in the future, the contract is void *ab initio*. Examples cited to substantiate this point of the law, is the sale of grape before it blackens, or an ear of grain before it whitens, or sale of milk in the teat.

Accordingly, the opinion of ancient Islamic jurists holds that the subject matter of contract must be in existence at the time of contracting, in addition to an immediate method of delivery. However, if the subject matter of contract does not exist at the time of contracting, though it is highly probable to be secured later, still the principle of gharar can be invoked to vitiate the contract. Again, if the thing exists in essence such as being in a manufacturing process, but has not yet finished the principle of gharar can also be invoked to vitiate a contract.

It is evident that non-existence of the goods subject matter of contract gives rise to a total failure of consideration, but this does not cover the situation where the goods though non-existent at the time of sale, but it is established that they will be available at a future date. It appears to me that the rationale behind the masses of ancient Islamic scholars' position is that, the purchaser should not take the risk that the subject matter might not exist. Thus, a contract cannot be concluded on an expectation

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<sup>69</sup> Cf. Guest A.G "Anson's Law of Contract" at p256 {Oxford University Press 26<sup>th</sup> ed.}

that the subject matter of contract will exist, even if the chance of its existence is an established one.

In contrast, at the English common law, validity of the contract will arise when the buyer brings an action for non-delivery. In the words of Professor Guest "There is, therefore, no absolute rule that a contract for the sale of a "*res extincta*" is necessarily void in English law. But if the true construction of the contract is that the parties entered into it on the footing that the subject matter was in existence, and that neither of them should bear the responsibility if this was not so, then the contract is void for mutual mistake".<sup>70</sup> Hence, at the English common law, non-existence of the subject matter of contract will be viewed as a mutual mistake situation which nullifies consent and avoids the contract.

It may be added that the theory of gharar as expounded by these ancient Islamic jurists does not draw a distinction between uncertainty as to substance, on the one hand, and uncertainty as to quality on the other hand. In both situations the contract is deemed to be invalid. In contrast, the common law system draws a distinction between a mistake as to substance and a mistake as to quality. A mistake of the former type will avoid the contract, whereas of the latter type will not.<sup>71</sup>

Some ancient Islamic jurists have adopted a very strict position. They have contended that mere identification of the subject of contract by description is not sufficient. The subject matter of contract must be corporeally present at the time of contracting. However, as to this issue a split of opinion can be discerned. Shafi'i line of thought has espoused the most stringent approach. Shafi'i's have

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<sup>70</sup> *Ibid at p. 259*

<sup>71</sup> *Ibid at p.260*

contended that sale of a non-present object though adequately described at the time of contracting, is impermissible on the ground of considerable gharar. Ibn Hanifa and Ibn Hanbal, have expressed the opinion that sale by description is permissible, provided that the purchaser shall exercise an option as to examination of the subject matter of sale.<sup>72</sup> However, Malik has taken a much more lenient approach. He has subscribed to the view that sale by description is permissible and binding, even without the need to stipulate an option.<sup>73</sup>

This Article maintains that, if the theory of gharar is accepted as expounded by ancient Islamic jurists, in such a rigid form, it would most likely hamper Islamic banks' dealings in the area of international commerce. The touchstone should be a search for the rationale behind the theory, rather than an application of a rigid, ancient theory which does not for all intents and purposes accord with present commercial practices. It seems absurd to vitiate a contract on the ground that the subject matter of sale was not available at the time of contracting, though it would most probably be available within a few weeks or months.

It is submitted that the prophetic tradition has prohibited particular sales, in instances where the seller is not in a position to guarantee delivery, such as sale of an embryo of a she-camel, or grape before it blackens. The rationale behind prohibition of such sales is the possibility of occurrence of ja'iha, i.e. damage. An agricultural holding might be damaged by flood, fire, locusts or frost or any other cause. Similarly, an embryo might die in his mother's womb. The other category of prohibited sales relates to particular pre-Islamic types of sales which involve

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<sup>72</sup> Cf. Sarkassi, *Mabsout* { Cairo-Ar—al-Saada Publications} vol.13 at p.55, see also Ibn Abideen "Rad al-Mahtar ala al-Dur al-Mukhtar" { Cairo-Bolag Publications} vol. 4 at p.59

<sup>73</sup> Cf. Al-Dusugi, *Mohamed Arafa*, "Hashiat" Cairo-Dar-Thia al-Kutub-al-Arabia vol.3 at p.106

gambling such as "mulamasa", "munabadha" and "hasat".<sup>74</sup> The rationale behind prohibition of these sales was their embracement of outright gambling.

It appears to me that the instances indicated by the prophetic tradition do not warrant predication that there exists inseparability between non-existence of an object and gharar. I am of the opinion that these ancient Islamic jurists have incorrectly interpreted the prophetic tradition to the effect that a non-existent subject at the time of contracting cannot under any circumstances be a subject of contract. Logical inference suggests that what invalidate a contract is gharar and not the non-existence of the subject matter at the time of contracting.

In support of this view, Ibn Qayyum and Ibn Taymiyyah, both are distinguished Hanbali jurists have permitted sale of a non-existent object in all kinds of contracts, provided that no considerable gharar is involved. In their view, it is sufficient that the non-existent object is adequately described to an extent which negatives uncertainty. Ibn Al Qayyum was reported to have said that "There exists no text either in the Quran or the Sunna or a saying relating to any of the prophet's companions that sale of a non-existent object is impermissible. In the Sunna, we trace prohibitions as to sale of things which are non-existent and some things which are in existence. Accordingly, the "illa", i.e. ratio of prohibition does not relate to the question of being in existence or non-existence. It rather relates to the state of being

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<sup>74</sup> *Mulamasa* was a pre-Islamic sale in which the buyer was entitled only to touch the commodity without having the chance to look to it. The commodity was either covered by something or kept in a dark place. *Munabadha*, was also a pre-Islamic sale whereby, the purchaser unconditionally agrees to purchase a particular commodity without having the right to undertake pre-examination. *Hasat* was another pre-Islamic sale whereby the purchaser unconditionally agrees to purchase a commodity on which a stone he throws may rest.

unable to deliver a thing, whether it is available or non-existent such as sale of a straying camel".<sup>75</sup>

Accordingly, the better view under Islamic law is that, it is permissible to conclude a contract in connection with a non-existent object as there exists no correlation in all contracts between non-existence and gharar. The touchstone is that, the subject matter of contract should be capable of delivery, besides being adequately described to an extent negating uncertainty.

As the theory of gharar as expounded by ancient Islamic jurists does not derive its origin from an express provision of the Quran or the Sunna, it seems meaningless to uphold the opinion of ancient Islamic jurists in a theory no longer workable in its rigid form. Present advancement requires an interpretation which serves people's best needs rather than blocking the way of these interests. Hence, it would seem most appropriate to argue down ancient Islamic jurists' writings on the gharar theory to an extent of removing unworkable rigidity. This can be done on the ground of a new juristic preference (istihsan).

### **(3) Hoarding**

Hoarding was expressly prohibited by God in Chapter Nine "Tauba" or Repentance, Verses 34 and 35 which ordain: "And there are those who bury gold and silver and spend it not in the way of God: announce unto them a most grievous penalty. On the day when heat will be produced out of that (wealth) in the fire of Hell, and with it will be branded their foreheads, their flanks, and their backs. This is the (treasure) which ye buried for yourselves. Taste ye then, the (treasures) which ye buried."

The prophet (peace be upon him) was reported to have said "If any one keeps goods until the price

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<sup>75</sup> Cf. *Ibn al-Q'ayyim* at p 113

risers, he is a sinner".<sup>76</sup> He also said "If anyone hoards grain for forty days then gives it charity that will not act as atonement for him".<sup>77</sup>

On account of this textual injunction ancient Islamic jurists have formulated practical rules prone to combat hoarding. With a view to securing basic commodities to the people they have expressed the opinion that the hoarder should be forced to sell what he has at the market price.<sup>78</sup>

Furthermore, the government is entitled to issue orders to seize any hoarded commodity and distribute it among the needy. This is expounded on the ground that, in Islamic jurisprudence, a person forced by need, in circumstances of famine, is permitted to take food which belongs to another, provided that he will reimburse the owner when he can afford that. In Islamic jurisprudence, the hoarder should be subjected to reasonable punishment as the judge may deem fit. It is plain that the rationale behind the prohibition of hoarding is to block means which tend to restrict a smooth flow of capital.<sup>79</sup>

On the same footing, Islam prohibits extravagance. In Chapter 25, Furgan or the Criterion, Verse 67 ordains "Those who, when they spend are not extravagant and not niggardly, but hold a just (balance) between those (extremes). Again in Chapter 17, Bani Israil, Verse 29 commands "Make not thy hand tied (like a niggard's) to the neck, nor stretch it forth, for its utmost reach so that thou become blameworthy and destitute."

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<sup>76</sup> Cf. *Muslim Ibn al-Hajjg, Sahih 9vol, Cairo 1349 at p.177, see also Shawkani, Mohamed Ibn Ali "Nail al-Awtar" Cairo vol. 5 at p.234, see also Mustadrak al-Hakim Cairo vol2 at p.12*

<sup>77</sup> *ibid*

<sup>78</sup> Cf. *Ibn Hazam, "Muhala" vol 9at p.65, see also Kasani, Bad'iah" Cairo - Jamaliah publications 1327H Vol. at5 129, see also Mirghanani, Al-Hiddiyah { Cairo-Halabi Publications) vol.9 at 127*

<sup>79</sup> Cf. *Shawkani at p. 95 and after*

The Islamic doctrine takes the position that extravagance leads to vices and also intensifies the gap between the rich and the poor which might cause hatred and class struggle. The basic rationale behind prohibition of extravagance is to avoid expending money in a manner adverse to public interest.

On principle, at Islamic Shari'a, it is not permissible for the government to intervene and fix prices. A just price is deemed to be the price established as a result of a free play of market forces. It was reported that the prophet, peace be upon him, refused to intervene to fix prices in instances where the prices of commodities had soared to a high level.<sup>80</sup>

As to the issue of price fixation, a difference of opinion among ancient jurists can be discerned. One division of ancient jurists has absolutely prohibited price fixation, whilst the other division has permitted price fixation.<sup>81</sup> The predominant view of masses of ancient Islamic jurists was that, market mechanism should be allowed to freely determine the prices. However, price fixation is permissible in the event that a just price is not available.<sup>82</sup>

At Islamic Shari'a on the ground of Al-Hisbah theory the state may intervene and implement price control besides supervision of the overall economic activity. Al-Hisbah can be defined as the state's power to monitor economic activities with a view to securing public necessities and blocking of hoarding,

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<sup>80</sup> Cf. Kassani, "Badi'ah Vol. 5 at p129, see also Ibn Qudamam" Mughni" vol. 4 at p.48

<sup>81</sup> Shafi' line of thought subscribes to the view that price fixation was prohibited. As to this opinion, see Shirbini al-Khateeb, Mughni al-Muhtag" vol4. at p. 38, Hanfi, Maliki and Hanbalis take the view that it is permissible. As to this opinion see Mirghinani, " al-Hiddiyah" vol.8 at 127, see also al-Baji, " al-Muntaga " vol 5 at p. 18

<sup>82</sup> Cf. Nail al-Awatar at p.232, see also Ibn Tayimyyah" Al-Hisbah" at p30, see also Ibn al-Murtada " a al-Bahr al-Zukhar" vol. 3 at 316

usurious practices and any other activity deemed to be adverse to the well-being of the economy.<sup>83</sup>

### **Conclusion**

The Islamic ideology furnishes the intellectual structure which governs the Islamic banking industry. Thus, elucidation of the substantive Islamic Shari'a principles in the area of finance is a must for a better understanding of why Islamic banks differently finance their banking operations.

"Riba" *i.e.* interest and "gharar" *i.e.* risk or uncertainty are two pivotal issues in Islamic jurisprudence. Most prohibited transactions are justified on the ground either of riba or gharar. The basic rationale behind the prohibition of riba is to curb exploitation. In consistent vein, yield should be commensurate with the risk undertaken by the bank. The magnitude of profit is justified on the volume of the risk involved. In the event that capital is not exposed to risk, on principle, yield on capital should be nothing. Any increment on capital not associated with risk and labour is deemed to be at Islamic Shari'a as impermissible.

The gharar theory as expounded by ancient Islamic jurists in its rigid form appears as an unworkable metaphysics. The interpretation given by ancient Islamic jurists to the prophetic tradition in this regard does not warrant predication that there exists inseparability between non-existence of an object at the time of contracting and gharar. The better view is to hold that, under Islamic law, it is permissible to sell a non-existent object at the time of contracting, insofar as the seller is capable of delivery. The touchstone should be capacity of the seller to deliver the subject matter of sale, and not the question

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<sup>83</sup> Cf. *Ibn Tayimyyah, "al-Turug al-Hukmiyah" at p.276*

whether the object of sale is available at the time of contracting or not. Dilution of the rigidity of the gharar theory is likely to provide the Islamic banking system with rules under which the system can flourish in an international financial community.