

## BANKING WITHOUT INTEREST: A CRITICAL LOOK AT THE FORM AND CONFIGURATION OF ISLAMIC BANKING SYSTEM

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### ABSTRACT

**P**rofit sharing (Islamic) banking is no longer a curiosity. It has become a force to be reckoned with in the financial market. It has brought about a great and endemic trend in the international financial market, a situation whereby banks either set up a profit sharing operation internally or start a new bank entirely based on the principle of profit sharing.

This work is therefore, focused at studying the form and configuration of Islamic banking with a view to find out why within a short span of time profit sharing banking was able to bring about revolution in the banking sector of the economy. We have tried as well, to find out what such revolution portends for the general members of the society.

### CONCEPTUAL BACKGROUND

For proper understanding and for a focused work, the following terms need to be defined:

(i) **Islamic Banking**

To be able to define Islamic banking there is the need to define Islam itself. Islam has been defined unanimously by Muslim scholars as the religion of peace and total submission to the will of Allah (God). The name Islam is a derivative of one of the attributes of Allah (SWT) AsSalaam, meaning the Lord of Peace. It is important to note that Islam is a comprehensive way of life that covers the whole gamut of human life in all its ramifications as it regulates every aspect of individual and communal life. Islamic banking is only distinct from western/conventional system in terms of its modus operandi. While the conventional system is interest based Islamic system on the other hand is profit sharing as Islam is averse to the act of giving and taking interest. Since Islam abhors the idea of payment and receipt of interest, it is thus pertinent to define interest.

(ii) **Interest**

The word 'interest' is defined in the '**American Heritage Dictionary**' as "A charge for loan, usually a percentage of the amount loaned"; and "An excess or bonus beyond what is expected or due".

The same term has been defined in '**Webster's Family Encyclopedia (Vol. 6)** as "the amount of money charged by a lender to a borrower for the use of a loan."

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Since Usury is the term used in virtually all religious literatures to denote or interest and owing to its propinquity to the same, particularly in the modern economic and banking parlance, it is therefore necessary to define this term so as to avoid unnecessary 'mix up' along the line.

### Usury

The *American Heritage Dictionary* defines usury as "the act of lending money at any rate of interest" and "interest charged or paid on a loan". *Webster's Family Encyclopedia* on the other hand defines the word as "the charging of interest for the loan of money".

It has to be noted that 'usury' is called "Riba" in Arabic and/or Islamic literature. It linguistically connotes 'increase in' or 'additional to' anything. Specifically, it refers to the additional sum which the creditor charged from the debtor at a fixed rate on the principal lent, that is, interest<sup>1</sup>.

### SIGNIFICANCE OF BANKING IN ANY ECONOMY

Banking is such an important institution in any economy as it mobilizes savings and idle funds so as to employ them gainfully in profitable ventures and also in the production of goods and services that are economically and socially beneficial to people. Among others, banks perform the duty of making funds available to people who can make fuller, proper and better use of them through commercial ventures. It sees to the re-allocation of capital and plays the important role of enabling the public and private sectors of the economy to fulfill their countless complementary claims on the economy. By giving credit in form of loan and/or discount to their customers, banks tend to increase production, expand capital investments and therefore encourage a higher standard of living.

Banks, in addition to the enumerated functions, perform the dual duties of saving as well as satisfying the desire for borrowing via free access to credit facilities, they facilitate exchange and help capital formation and production on a large scale.

Other functions of banks include keeping deposit for customers, safe custody for valuables, such as jewelries, important papers and valuable documents receipts, etc.; of course, for reasonable charges, payment for and receipt of bills on behalf of their clients, transfer to money from one bank to another, leasing of equipments to firms in their production of goods and services, offering of advisory and consultancy services to the newly established firms as well as helping ones on how their resources could be best utilized for efficient development and growth of their business concern.

It is crystal clear from the foregoing that no economy can do without banking institution. However, it is disheartening to note that modern banking system is afflicted with spectrum of problems owing to its mode of operations. Modern/conventional banking is interest based. Since interest has its socio-economic problems modern banking system therefore, no doubt would not be free from such problems as it derives its very life blood from interest.

Sidiqqi (1979) lamented thus:

*'The way the modern banking perform these function has been*

largely responsible for some of the greatest evils of modern economy, iniquities in the distribution of wealth and endemic tendency towards inflation and fast accumulation of debt in several sectors of the economy with serious political, economic and sociological consequences. The system therefore calls for a close scrutiny in the study which advocates a basic reform in the banking, that would eliminate these ills and gear the system to the universally acclaimed ends of justice, equity and progress<sup>2</sup>."

There is no doubt, interest causes inflation, instability of the economy as well as unemployment as funds are not invested in Agriculture, commerce and industry etc, but into lending business.

Lending his voice to the issue in question, Chapra (1982) states:

*"The instability has persisted and the uncertainty has continued. After going through the throes of painfully high levels of inflation, the world economy has experienced a deep recession and unprecedented rate of unemployment, complicated further by high level of real interest rates and unhealthy exchange rate fluctuations. Although, the recovery is on the way, the uncertainty still prevails. Real interest rates continue to be high and are expected to rise further, thus raising fear of an aborted recovery. The crisis is further aggravated by the presence of extreme poverty amidst plenty in all countries, various forms of socio-economic injustice, large balance of payments deficit and inability of some developing countries to service their staggering debt"*<sup>3</sup>.

Modern banking system is well entrenched in the capitalist economy since capitalism concentrates the wealth of nation. I mean, the means of production in the hands of few capitalists, it is therefore irreligious and unislamic. About this, Mr. Keynes posit that *"modern capitalism is absolutely irreligious, without internal union, without much public spirit, often though not always, a mere congeries of possessors and pursurers"*<sup>4</sup>.

The problem of interest, which constitutes the very life blood of modern banking is becoming endemic and therefore a source of worry to so many people. According to Naiwan Osahan (1999): *"our banks are not operating as banks, but as money collecting points officially licenced to drain their customers of their resources. They are not empowering the economy nor funding productivity"*<sup>5</sup>. Since religion is to cater for the material and spiritual well-being of man, no religion worth the name would allow the payment and receipt of interest owing to its anti social nature. It concentrates the wealth of a nation in the hands of few members of the society and brings about ill-will amongst them.

R.H. Tawney (1937) writes: *"But on the iniquity of payment merely for the act of lending, theological opinion, whether liberal or conservative, was unanimous, and its modern interpreter, who sees in its indulgence to interesse the condonation of interest have created a scandal in theological circles in any age before that of*

*Calvin. To take usury is contrary to scripture; it is contrary to Aristotle; it is contrary to nature, for its is to live without labour; it is to sell time, which belongs to God, for the advantage of wicked men; it is to rob those who use the money lent, and to whom, since they make it profitable, the profits should belong; it is unjust in itself, for the benefit of the loan to the borrower cannot exceed the value of the principal sum lent him it is in defiance of sound juristic principles, for when a loan of money is made, the property in the thing lent passes to the borrower, and why should the creditor demand payment from a man who is merely using what is now his own<sup>16</sup>*

One can therefore, based on the foregoing see the reason why Islam and its adherents the act of payment and/or receipt of interest/usury in whatever form it may take. One can equally see the reason; apart from the tendency among Muslims these days to return to the basis of their religion that the realization of problems associated with interest-oriented banking prompted the urge to go for a sharing (Islamic) form of banking.

We shall now look into the wisdom behind the Islamic interdiction of interest.

#### **ISLAMIC INTERDICTION OF INTEREST *RAISON D'ETRE***

There are several verses of the Qur'an and the ahadith of the prophet the primary source of Islamic law which interdict the receipt and payment of usury. Some of those verses of the Qur'an as well as ahadith of the prophet will be cited while opinions of scholars on them shall equally be examined.

#### **Qur'an**

The Qur'an, according to the Muslims, speaks the mind of Allah as every word and of course each alphabet is believed to be utterances made by God Himself. By Qur'an therefore, we refer to the position of Allah (God) on interest.

*"O believers, devour not usury, doubling it rate many times. Have fear of Allah, and you shall prosper, guard yourselves against the fire prepared for the unbelievers" Qur'an 3: 130 . 1.*

*"That which you lay out for increase through the property of (other) people, will have no increase with God: But that which you lay out for Charity, seeking the countenance of God (will increase) it is these who will get a recompense multiplied" Qur'an 3.39.*

*"Those who devour usury shall rise up before Allah like a man whom Satan has demented by his touch; for they claim that usury is like trading, but Allah has permitted trading and forbidden usury. He that receives an admonition from his Lord and mends his way may keep what he had already*

earned, his fate is in the hands of Allah. But he that pays no heed shall be among the people of the fire and shall remain in it forever" Q 2:275.

"Allah has laid His curse on Usury and blessed alms giving with increase He bears no love for the ungrateful". Q 2:276.

"O ye who believe! Fear God, and give up what remains of your demand for usury, if you are indeed believers. If you do it not, take notice of war from God and His Apostle. But if you turn back, you shall have your principal (sum): deal not unjustly, and you shall not be dealt with unjustly" Q 2:278-279.

"Because of their iniquity, we forbade the Jews good things which were formerly allowed them; because time after time, they debarred others from the path of Allah; because they practice usury although they were forbidden it and cheat others of their possessions. We have prepared a stern chastisement for those of them that disbelieve" Q 4:161.

### Hadith

Hadith means the tradition of the prophet Muhammad (SAW). These are the explanation given by him for further elucidation of the injunctions of the Qur'an. Hence, Hadith or the Sunnah in this context could be said to be the position of the prophet on usury or interest.

Abu Hurayrah related that the prophet Muhammed (SAW) said:

*"On the night of **Mihraj** (i.e. ascension of the prophet to heaven), I came upon a group of people whose bellies were like houses. They were full of snakes, which could be seen from outside their bellies. I asked (angel) Gabriel who they were, and he told me that they were people who had practiced "**Riba**" (Interest)".*

Jabir related that the prophet (SAW) once cursed the one who accepted '**Riba**' (i.e. usury of interest), the one who paid it, the one who recorded it, and the two witnesses to it, saying that they are all alike".

Abdullah ibn Hanjalah reported that the holy prophet once said: *"A **dirham**' (i.e. the smallest unit of currency in some Arab countries) of '**Riba**' deliberately taken by a man is a sin worse than committing '**Zina**' (i.e. fornication or adultery) thirty times".*

Can it take to scripture; it is contrary to Allah's will; it is to live without labour; it is to seek for the advantage of wicked men; it is those whom, and to whom, since they are sinful, they belong; it is unjust in itself, for the benefit of the creditor cannot exceed the value of the principal sum; in defiance of sound juristic principles of former ages made, the property in the thing is not in the creditor; why should the creditor be paid for merely using what is now his own?

Can one therefore, seeing the reason why Islam forbids interest and the receipt of interest/usury in whatever form it may take, see the reason, apart from the tendency among the Muslims, on the basis of their religion that the realization of the principles associated with banking prompted the urge to go for profit (Islamic) form of

Will not one kind of the Islamic interdiction of interest.

### ISLAMIC RESTRICTIONS ON SON D'ETRE

There are two primary prohibitions in the receipt and payment of usury interest. See those as well as ahadith of the prophet will be quoted which are of equal importance and shall equally be examined.

#### The Qur'an

The Qur'an, which speaks the mind of Allah as every word and verse believed to be utterances made by God Himself. See the prohibition of Allah (God) on interest.

*Those who say, doubling it rate many times. We fear Allah, O ye who believe, guard yourselves against the fire which is prepared for the disbelievers" Qur'an 3: 130 1.*

*That which ye give through the property of other people, will be counted as a loan which will increase. It is not a recompense multiplied" Qur'an 3.39.*

*Those who step before Allah like a man whom Satan has touched; for they claim that*

earned, his fate is in the hands of Allah. But he that pays no heed shall be among the people of the fire and shall remain in it forever" Q 2:275.

"Allah has laid His curse on Usury and blessed alms giving with increase He bears no love for the ungrateful". Q 2:276.

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"Because of their iniquity, we forbade the Jews good things which were formerly allowed them; because time after time, they debarred others from the path of Allah; because they practice usury although they were forbidden it and cheat others of their possessions. We have prepared a stern chastisement for those of them that disbelieve" Q 4:161.

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In yet another frontal attack on the devourers of 'Riba' (usury) Muhammad (SAW) was reported to have said: "*Riba has seventy three forms, the simplest of which is like a man performing sex (incest) with his own mother*" the above underlined similes illustrate in graphic forms Islam's fervent opposition to even the minutest and seemingly innocuous practice of interest.

Finally, the Prophet Muhammed (SAW) warned the believers in his farewell sermon delivered to the *Ummah* (the Muslim Community) during the last hajj/pilgrimage performed by him:

*"Allah has forbidden you to take usury (interest), therefore, all interest obligation shall henceforth be waived, your capital, however, is yours to keep. You will neither inflict nor suffer inequity. Allah has judged that there shall not be interest and that all the interest due to Abbas ibn Al Mutalib shall henceforth be waived".*

The foregoing *Ahadith* of the prophet, no doubt, adequately shed more light on, corroborates and complement the relevant verses of the Qur'an on the above subject, yet there is the need to look at the interpretation given to them by some scholars. Meanwhile in order to balance this work, we shall look at the position of economists who happened to be protagonists of interest.

## THE ECONOMISTS AND INTEREST

Many theories have been propounded by different economists and several other scholars for and against the payment of interest. Famous among them are: Time Preference Theory, Abstinence Theory and Liquidity Preference Theory.

### Time Preference Theory

This theory was propounded by an Austrian economist by the name of Bohm Bhowerk who explained the rationale behind the payment and receipt of interest and its rate in forms of time preference; that is, the concept of technical superiority of the present over the future; which implies that an average person prefers present over the future, and so if he is required to forego the present comfort or use of his funds, he is entitled to some compensation in the name of interest. This position is wrong and erroneous<sup>9</sup>. According to Aristotle, money is just like a barren hen which lays no egg.

Qureshi (1976) argued that the position or the explanation was based on false psychological assumption<sup>9</sup> while Mawdudi (1961) accepted it as an explanation of interest, but explanation, he believes, is not synonymous with justification<sup>10</sup>. In a letter written by John Locke to a friend, a frank refutation of interest could be deduced.



**"High interest decays trade. The advantages from interest is greater than the profit from trade, which makes the rich merchants give over, and put their stock to interest, and the lesser merchants break"**

### **Abstinence Theory**

This theory was propounded by SENIOR to justify the payment and receipt of interest. By this theory, Senior's idea suggests that people are required or forced to save. In his word, the profit of capital is the wages of abstinence". This idea of abstinence was generally criticized on the ground that it suggests positive discomfort, whereas the aristocrats save without least inconvenience. It was as a result of this criticism that the socialist writer, Lassale, ridiculed Senior by saying that 'the profit of capital is the wages of abstinence'. Waiting was substituted for abstinence as a result of these criticisms by Marshall who belongs to Senior School of thought. This theory as well as virtually every other ones fails to answer the fundamental question: Why is interest paid at all?

**Liquidity Preference Theory**  
This theory was initiated by Keynes. He argues that liquidity preference justifies charging of interest on the supply side and a concept of marginal efficiency of capital on the demand side.<sup>12</sup> According to him, these are the two forces which determine the rate of interest. This theory is seriously refuted by Cole who says: *"finance by itself produces nothing, and money is of value only for the buying of things. It is therefore plainly wrong for monetary condition to govern, industry or for production to be the hand maid of finance"*.

Abu (1957) warned against the tendency of treating money capital as if it were capital goods or real assets, a tendency that has become quite frequent in modern literature. Samuelson (1986) maintained that money is a means of transferring one good to another by exchange rather than by production. This position of his warrants him to treat money as any other commodity that has a price or a rental.

He opined that interest is the price with the rental use of money, creating the impression that to use the service of money is exactly as to use the service of a doctor or a tractor. He argued further that when money is sold one should pay a price and if borrowed one should pay a rent. To sell money, there must be some exchange of one good for another, to him money is sold for money. This seems, of course, to be erroneous.

According to Mobolaji (1990), every rent comprises an element of depreciation, but money as a medium of exchange, he says, is not suppose to depreciate. He argues further that one does not rent something that perishes or disappear once used; but when you use money, you lose it forever just like that, how then can it be rented?

### **THE MUSLIM SCHOLARS**

Owing to shortage of space, a cursory look shall be taken at the interpretation of Muslim scholars of Qur'an 2.275. According to At-Taba'tabai (1973) interest nullifies the demand of nature and destroys the basis of the

onomy...interest is therefore, diametrically opposed to the balance and equilibrium of society, it destroys that system which man had created with the balance of the Divine creation.<sup>13</sup>

In the opinion of Abul Ala Maududi, the Qur'an likens the money lender to a madman, because just as a madman loses his sense of account of disordered intellect, in the same vain the money lender is so mad for money making that he forces himself from common sense.

... The (interest-taker) base their vice on a wrong theory without seeing the fundamental differences between profit and interest. They argue like this; when profit on capital is lawful in trade, why then would interest on money invested in trade be unlawful?... However, what they forget is that there is no business in the whole world where there is a fixed and guaranteed profit without any risk. In trade, commerce, industry, agriculture etc: one has to dissipate energy and spend time and capital and at the same time one has to face risks, without any guarantee of a profit.<sup>14</sup>

According to Yusuf Ali (1934) "*where-as legitimate trade or industry increases the prosperity and stability of men and nations, a dependence on usury merely encourages a race of idlers, cruel blood suckers, and worthless fellows who do not know their own good and therefore akin to madmen. Islam accepts no distinction, in so far as prohibition of interest is concerned, between reasonable and exorbitant rate of interest, and what come to be reckoned as the differences between usury and interest nor between the returns on bonus for consumption and those for production proposes and so on*".<sup>15</sup>

Imam Ar-Razi (1986) considers a man's property to be as sacred as his blood and so to appropriate it to oneself without legitimate reason is **haram** a sin against God and a crime against humanity. According to him, dependence on interest discourages people from working to earn their livelihood, since one can easily make more money by investing in loan. This would neither foster unity nor facilitate the development and growth of the economy.<sup>16</sup>

## THE FORM AND CONFIGURATION OF INTEREST FREE (ISLAMIC) BANKING SYSTEM

*"People think Islamic finance must be complicated. Actually these instruments are no more difficult to explain than such banking concepts as collateralization. Any businessman who can understand that can certainly understand Islamic (banking) economics".*

The form or modus operandi of Islamic (interest free) banking can be examined under the following headings: *Murabaha, Mudarabah, Ijarah, Musaqat, Musharakah and Mozara'ah.*

**Murabaha**

This is usually one of the instruments used by the commercial or merchant banks to carry out its functions. It signifies the commercial (financial) agreement, which are usually short-term. Under this arrangement the lender acquires the materials or the items needed by the borrower; the ownership being retained by the creditor, the bank sells the goods to the borrower on an agreed date at a profit. For instance, a bank that agrees to finance a construction (may be a building) might purchase raw building materials with its own name and sell them to the construction company.

By paying at a later date / time when the construction would have been accomplished and sold, if it is a building for either commercial or residential purposes, the bank and its investors gain a return on their funds. The return/profit is based on the risk that the bank undertook when it first acquires the materials, and asset as well as on the increase in value of the product.

Thus, the bank's charge is calculated based on a formula that cater for the cost of other financing available to the business, which ensures that financing from Islamic bank is competitive. This is the most commonly used transaction in Islamic banking.

**Modarabah**

This is a form of partnership approved by Islamic law. This has been in existence right from the period of '*Jahilliyah*' (ignorance) in the Arabian peninsula, it is a short-term form of arrangement whereby one party provides fund and the other labour and expertise. Islam regards human capital of labour as equal to financial capital, profit is thus shared between the parties and losses are borne exclusively by the lender for the borrower has paid his own via his productive labour or efforts, risks and expertise. This is the kind of partnership engaged in by Muhammad (SAW) with Khadijah who later became his wife. Obviously, only borrowers who enjoy high level of confidence of the lending institution would be extended modarabah financial arrangement. A common variation is the two tier '*Modarabah*' whereby a man (businessman) or bank organizes investors' money into a fund and disburse it into *Modarabah* contract with a manager or entrepreneur. It is a common place nowadays that a number of western banks now offer *Modarabah* funds to Islamic investors.

**Musharakah**

This is a kind of transaction that offers equitable participation to investors on partnership basis in project financing or business (commercial) transaction. It is usually long term, with high take off (investment) and limited short-term return. This is the most appropriate form of partnership especially in a joint venture to build a power station etc, whereby a bank and entrepreneur provide fund and contractor to handle construction, engineering and operation of the available tools and facilities. Ordinarily, shares of profit and loss are agreed to, just at the inception of the partnership/contract.

**Mosara'ah**

This is especially designed for agricultural projects; they allow a farmer or agricultural enterprise or firm to acquire the necessary equipment, materials and seeds or fertilizer needed. Such items are obtained by bank, individuals or corporate entities, which stands as partner with the farmer, who contributes land and productive labour to the project or venture. **Ijara**

This is the transaction that has to do with leasing and hire purchase of such items as vehicles, aircrafts, machinery and or computer equipments. Essentially, the Islamic leasing system works the same way as the western leasing system, that the lessee receives the service (utility) of equipments where as the lessor retains the ownership. In return, the lessor takes a pre-arranged amount amortised over the life of the equipment or project or rather the contract. There are some additional conditions, guidelines and principles, including the Islamic notion that the leased assets must be put to productive use, rather than simply using the leased item to produce a paper profit. It is on record that there is an increasing amount of co-operation in Ijara transaction between western lenders (banks) and Islamic banks. For instance, the Islamic Development Banks (IDB), an international financial institution has jointly financed a number of Ijara contracts or projects with the World Bank. For example, in 1991, the IDB provided \$16 Million in lease financing (project) to underwrite facilities expansion for the Arab Potash Company with the World Bank contributing \$20 million.

**Musaqat**

This is very similar to Mosara'ah. It has to do with agricultural projects. Although Musaqat arrangement has to do basically with land, for instance, irrigation, drainage, etc on the farmland.

**CONCLUSION**

Islamic banking system unlike the conventional system operates on the basis of profit and loss sharing. The frequently asked question (FAQ) therefore, is how would such banks offset its administrative and allied costs. From the foregoing, it is crystal clear that income are generated through other means which are beneficial to the parties concerned.

Owing to the fact that Islamic banking system guarantees even distribution of wealth of the nation, facilitate employment and slam the door to recession and poverty amidst plenty in most of the capitalist economy; it goes therefore to show that all of the aforementioned advantages account for its adoption by people.

Importantly, by the west, who, one could have expected to have some reservation against it. Of course, it is not surprising as knowledge is universal and as whatever could bring about the much needed peace and happiness is the very aim of acquiring knowledge.

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