

ISLAMIC FINANCIAL SYSTEM:
WITH SPECIAL REFERENCE TO
BANKING AND INSURANCE

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- I. The Islamic financial system is not a totally autonomous system. It is an integral part of the Islamic economic system which again is an integral part of the Islamic social order or deen. It is therefore essential that the Islamic financial system should be studied in the context of the Islamic way of life and its blessings can also be ensured only if it is accompanied by an effort to establish the Islamic order in its entirety.

The Islamic financial system is also unique in the sense that its objectives, values, principles, institutions and modes of operation are parts of an organic whole, while there may be certain apparent similarities between some of the aspects of an Islamic economy or Islamic financial system with those of materialism or socialism, but in fact in spirit and substance both the concepts and institutions of the Islamic financial system should be seen and understood in the context of the Islamic system and not otherwise. These two clarifications are essential to understand the real ethos of the Islamic financial system.

- II. There are many aspects of the uniqueness of the Islamic financial and economic system, but the following deserve to be noted carefully:
1. The Islamic economy is a derivative of the Shariah. Its moral and intellectual foundations are rooted in the concept of Tawhid, Risalah and Akhira. It is in the context of the Divine Sovereignty and the Divine system of human and universal sustenance (rububiyah) that the Islamic financial and economic system can be understood. That is why the most distinctive aspect of the Islamic financial and economic system is the integration of the moral and the material aspect. This is basically different from the approach of the contemporary economic ideologies which claim to be value-neutral and are not primarily concerned with the moral dimension.
 2. A natural corollary of the Islamic concept of Tawhid is that all that exists belongs to Allah, subhanahu wata'ala. From this follows the unique Islamic concept of ownership of wealth and property. While individual has been given the authority and control over wealth and property, he is not its absolute owner, but only a trustee so that he could use it for the purposes which Shariah has sanctioned which include fulfillment of his and his family's needs, the needs for future production and business expansion, the socio-

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-economic needs of the Islamic Ummah and the human society at large. But no one has a right to exploit anyone, make a living through means in contravention of the Shariah or to spend them in manners prohibited by Islam.

3. The objective of all human efforts and particularly of the economic and the financial system is the establishment of a just society. The Prophets of Allah were sent to establish justice amongst human beings and the Qur'an makes it abundantly clear that establishment of justice in all aspects of life is the primary objective of an Islamic order. Some references from the Qur'an are given below:

- "Maintaining His creation in justice..." (III: 18)
- "Those of mankind who enjoy equity..." (III: 21)
- "Be ye staunch in justice..." (IV: 135)
- "Witnesses for Allah in equity..." (V: 8)
- "Judge between them with equity" (V: 42)
- "Give full measure and full weight, in justice" (VI:153)
- "Say: My Lord enjoineeth justice" (VII: 29)
- "And weight with the true balance" (XXVI: 182)
- "Act equitably" (XLIX: 9)
- "And observe the measures justly..." (LV: 9)
- "That mankind may observe right measure" (LVII: 25)

4. The purpose of all economic activity is to seek well-being of human beings personal as well as of others. Islam is neither obsessed with growth nor with maximization of personal gains only. That is why welfare orientation is of prime importance in Islamic economic and financial system. Capitalistic economics is want-oriented while Islamic economy is need- and welfare- oriented.

III. In the light of the above considerations, it would be worthwhile to spend a few moments in reflecting upon the nature and role of money in an Islamic society. Money is primarily a medium of exchange and a measure of value. If money's role is confined to these two major functions, money would not become a commodity in itself and would remain only an instrument for facilitating economic activity. In the Western economics, two new functions were also assigned to money, i.e. of store of value and of being a standard for deferred payments. To the extent money has to play a role in inter-temporal terms, the role of being a store and a standard can easily be taken care of by the two initial functions of 'medium' and 'measure'. Once money becomes a commodity and is used as a store not merely of value but becomes a valuable commodity itself, it departs from the original role and introduces a number

of falsifications and distortions in the economy. In the Islamic financial system, money is to play the original function only and would not be allowed to become a commodity in itself. This is where the uniqueness of the Islamic approach lies because this makes it distinct both from capitalism and Communism.

IV. In the light of the above mentioned role of money, the Islamic financial system is based upon three basic principles:

1. Abolition of riba (interest and usury) in all its forms
2. Affirmation of the principles of risk-sharing and equity- sharing as the basis for economic activities and enterprise
3. A detailed framework of moral guidance to make economic activity bound by ethical norms

Islam establishes financial institutions and relationships on the basis of the above mentioned principles. Credit and banking have a role in the Islamic economy, but the basis on which they are organized are fundamentally different from the ones on which they operate in- the contemporary world, both capitalistic as well as Communistic.

V. The prohibition of riba is the kingpin of the Islamic system. It must be clearly understood that riba means any predetermined fixed return on loan money charged by the lender from the borrower and calculated in relation to the time for which the loan money has been used by the borrower. Any such increase on the original amount lent is riba and has been forbidden by Islam. While the injunctions about the prohibition of riba. were revealed gradually and one can see an evolution towards a totally/free economy in the Madani period of the Prophetic era, the authentic and almost universally accepted Islamic position is as follows:

1. Interest and usury both are covered by the term riba which includes simple interest as well as compound interest.
2. Loans given for commercial purposes or for production purposes are at parkas far as the question of riba/interest is concerned. Interest on production loans is prohibited in the same way as interest on commercial loans.
3. Whether interest is charged by individuals or by institutions both are forbidden in Islam. There is no moral or rational ground to differentiate between the private money and the institutional bankers.
4. Loan transactions whether between private individuals or between private individuals and institutions or between private individuals and public sector/government or within private sector/government organizations, have to be riba-free. There cannot be any justification for prohibiting

interest in the private sector and allowing the same in the public sector or in dealings between the private individual and the government.

Prohibition of interest covers all the above delineated areas of economic activity.

VI. The Qur'an and Sunnah are very clear, categorical as well as forceful on the prohibition of riba.

1. First Revelation (Surah al-Rum, verse 39) That which you give as interest to increase the peoples' wealth increases not with God; but that which you give in charity, seeking the goodwill of God, multiplies manifold.

(30: 39)

2. Second Revelation (Surah al-Nisa', verse 161) and for their taking interest even though it was forbidden for them, and their wrongful appropriation of other peoples' property. We have prepared for those among them who reject faith a grievous punishment.

(4: 161)

3. Third Revelation (Surah Al 'Imran, verses 130-2) 'O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the Prophet so that you may receive mercy'.

(3: 130-2)

4. Fourth Revelation (Surah al-Baqarah, verses 275-81) those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: "Trade is like interest" while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist may have what has already passed, their case being entrusted to God; but those who revert shall be the inhabitants of the fire and abide therein for ever (275). God deprives interest of all blessing, but blesses charity; He loves not the ungrateful sinner (276) Those who believe, perform good deeds, establish prayer and pay the zakat, their reward is with their Lord; neither should they have any fear, nor shall they grieve (277). O believers, fear God, and give up the interest that remains outstanding if you are believers (278). If you do not do so, then be sure of being at war with God and His Messenger. But, if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it (279). If the debtor is in difficulty, let him have respite until it is easier, but if you forego out of charity, it is better for you if you realize (280). And fear the Day when you shall be returned to the Lord and every soul shall be paid in full what it has earned and no one shall be wronged (281).

(2: 275-81)

Riba in Hadith

1. From Jabir: The Prophet, may peace be on him, cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said: "They are all alike (in guilt)" (Muslim, Kitab al-Musaqat, Bab la'ni akili al-riba wa mu'kilihi; also in Tirmidhi and Musnad Ahmad).
2. Jabir ibn 'Abdullah, giving a report on the Prophet's Farewell Pilgrimage, said: The Prophet, peace be on him, addressed the people and said "All of the riba of Jahiliyyah is annulled. The first riba that I annul is our riba, that accruing to 'Abbas ibn 'Abd al-Muttalib (the Prophet's uncle); it is being cancelled completely" (Muslim, Kitab al-Hajj, Bab Hajjati al-Nabi, May peace be on him; also in Musnad Ahmad).
3. From 'Abdullah ibn Hanzalah: The Prophet, peace be on him, said: "A dirham of riba which a man receives knowingly is worse than committing adultery thirty-six times" (Mishkat al-Masabih, Kitab al-Buyu', Bab al-riba, on the authority of Ahmad and Daraqutni). Bayhaqi has also reported the above hadith in Shu'ab al-iman with the addition that "Hell befits him whose flesh has been nourished by the unlawful" (ibid).
4. From Abu Hurairah: The Prophet, peace be on him, said: "On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received interest" (Ibn Majah, Kitab al-Tijarat, Bab al- taghlizi fi al-riba, also in Musnad Ahmad).
5. From Abu Hurairah: The Prophet, peace be on him, said: "Riba has seventy segments, the least serious being equioal- ent to a man committing adultery with his own mother" (Ibn Majah, ibid).
6. From Abu Hurairah: The Prophet, peace be on him, said; "There will certainly come a time for mankind when everyone will take riba and if he does not do so, its dust will reach him" (Abu Daud, Kitab al-Buyu', Bab fi ijtinabi al-shubuhah; also in Ibn Majah).
7. From Abu Hurairah: The Prophet, peace be on him, said: "God would be justified in not allowing four persons to enter paradise or to taste its blessings; he who drinks habitually, he who takes riba, he who usurps an orphan's property without right, and he who is undutiful to his parents" (Mustadrak al-Hakim, Kitab al-Buyu').

Now it would be worthwhile to understand why Islam prohibits riba.

I would concentrate only on three points:

1. A riba-based economy is a money centred economy. Money becomes a commodity and is coveted in its own right and not merely as an instrument for exchanging real resources.
2. Pre-determined and fixed return irrespective of the risks of business is a form of exploitation, both of the lender as well as of the borrower, but more commonly of the borrower. That is why the Qur'an has called it an act of exploitation and repression (zulm). An exploitation-free society cannot be established without abolishing riba in all its forms.
3. The Islamic vision of the economic life of an individual as well as of society is one in which everyone lives within one's means, in which God-given resources are developed, shared and utilized, but there is no major chasm between the real resources and the financial resources. In other words, the fiduciary element in economic life has to be minimized. On the other hand a riba-based society is always expanding the fiduciary side and the gulf between the real and the monetary is expanding. Islam does not want a debt-ridden society, but a society where individual freedom is not hedged by perpetual economic indebtedness.

VII. As a short digression it may also be clarified that economic theory fails to provide any real rational justification for interest. If the whole discussion is summarized, it may be said that three major justifications are being offered in the literature.

1. Interest encourages savings and without interest savings may not take place, at least to the extent necessary for economic prosperity and well-being.
2. Interest plays a crucial role in allocation of resources for investment.
3. Interest plays an accounting role through which valuation of assets takes place.

An examination of all the three arguments shows that the arguments are very weak, fragile and one-sided. There is no denying the fact that incentive of return helps savings, but return does not mean necessarily a pre-determined fixed return. A variable return can also be a strong incentive to save, in fact, a much more powerful incentive as variability assumes possibilities of even higher return. There is great confusion about the second argument because in the last analysis it is the profitability of the project which is responsible for the allocation of resources and not just

interest. The same confusion underlies the third argument because evaluation of assets can take place on the basis of an average profit rate. Interest is" not crucial.

Before we proceed further, it must be very clearly understood that Islam prohibits riba which is a pre-determined fixed return on capital. Islam does not prohibit a return of capital as such. If the return on capital is variable and is related to the risks of the enterprise and its profitability, Islam not only allows that, but wants to establish the financial and economic system on this new basis. So a key to the Islamic financial system is prohibition of riba and reorganization of the banking and economic life on the basis of profit and risk sharing.

VIII. While Muslims did develop an elaborate system for credit and finance, the form in which banking is known in the contemporary world had its origins in the era of merchant capitalism of Western Europe. During the last eight centuries banking has evolved on the basis of interest and that is why the Western banking system is rooted in the institution of interest. Interest-based banking can have no place in an Islamic society. But there can be alternate forms of banking and financial institutions which would be free from the weaknesses from which the Western banking system suffers. From an Islamic viewpoint, its major drawbacks are as follows:

1. It is interest-based.
2. Whole of the loan process is based upon availability of financial collateral. It is not the viability of the project, but the financial capability of the borrowing party that is crucial to the whole lending policies of Western banks. This means that wealth would attract wealth and availability of financial collateral would be decisive in business operations and not the real worth of the project.
3. The Western banking system generates economic inequalities. In the final analysis it makes available to a limited class of people the financial resources of the entire community. Savings of the many are harnessed to fulfill the interests of the few. There is a built-in transfer of resources from the common people to the rich financiers and this leads to exploitation and injustice in the system.
4. There is also a built-in tendency artificial and fiduciary expansion of the economy which leads to instability of the economic system. Inflation and trade cycles are natural products of this system.

That is why it is important that the Muslim societies are not blindly following the Western banking system and strive for the establishment of their own financial institutions.

IX. What is the alternative under the Islamic system?

We shall discuss that in three sub-sections:

1. Consumption loans. Private individuals need to augment their financial resources through borrowings. Interest banks do provide private consumers with these resources. While Islam does not deny the need for social and institutional arrangements for meeting private consumption needs, Islam tries to approach the problem in a different manner. It raises the question why after all an individual has to borrow. It could only be for three reasons:
 - i. His income is not enough to meet his real needs, immediate as well as medium period" and has to fall back upon borrowings. If this is the situation interest-based loans for consumption purposes are no answer to the problem. In fact they perpetuate the plight of the borrower who would never be in the position to pay back all his loans. The answer lies in a just wages and incomes policy so that every individual gets a wage enough to meet his genuine needs.
 - ii. While his income is only to meet his genuine needs, he is addicted to, or has been persuaded through advertising media, to a lifestyle beyond his means. If this is the situation then the answer lies in curtailing non-genuine wants and not in providing facilities to maintain a lifestyle beyond one's means. The Islamic prohibition of Israf and Tabzir relate to this area.
 - iii. Normally the income of a person is enough to meet his needs, but there are some special circumstances which are genuine and for which he needs supplementary resources. Islam feels this is genuine and for that there should be arrangements both at the individual or family level and at the institutional and social level to meet these needs. But this should not be tied to interest based loans. Such resources should be provided without interest either voluntarily or through social or state agencies or Awqaf as public amenities. In Muslim history, a number of institutions were developed to cater for these needs.
- X. Commercial and Investment Loans. Islam believes that resources should be pooled on the basis of Shirakah or Mudharaba to cater for these needs. Islamic financial institutions and banks can also operate on the same principles. The depositor-banker relationship and the banker-borrower relationship both would be governed by the principles of profit-sharing. A complete blueprint of such banking has been developed by Muslim economists and a summary statement of the same is given in the Report of the Islamic Ideology Council of Pakistan. Around forty banks are presently operating

in different parts of the Muslim world on these principles. Some of the instruments they have developed are as follows:

1. Investment accounts in which depositors can keep their money with the proviso that the bank has the authority to use these resources for investment purposes and the bank declares on a six-monthly or annual basis that part of its profit be distributed amongst its depositors' investment accounts depending upon bank's actual profitability.
2. Investment loans, short-term as well as medium- and long- term to businessmen or business institutions, on the basis of profit sharing.
3. Leasing where the bank buys the commodity instruments machinery etc and leases out the name to the entrepreneur for use on the basis either of rent or hire purchase.
4. Mudharaba where the banker purchases a commodity on behalf of the entrepreneur and resells to him at an agreed profit. This is commercially known as mark-up. While this is permitted in circumstances where other modes of lending investment are not available, this instrument has to be used with great care otherwise it can degenerate into a form of riba.
5. Participation termed certificates these are profit-oriented debentures for short and long period finance.
6. Auctioning where the banker can develop a particular project and then auction it on a turnkey basis having a profit of its own.

This list is not exhaustive, but it shows how new instruments are being developed to undertake investment on Islamic principles. It must be realized that the Islamic banker is not merely a borrower or lender of money. It has an entrepreneurial role to play. The investments are oriented towards the projects and not merely the financial capabilities of the borrower. The return is based upon the actual profitability and not on assumed profitability. This ensures greater care as well as greater emphasis on real growth and not just fiduciary expansion. Because of this, all prospective entrepreneurs stand a greater chance to translate their talent and skills into economic enterprise with the help of the banking and financial institutions. This would ensure greater economic opportunities and expansion of entrepreneurial opportunities in society.

- XI.** Government and Public Sector and Central Banking. This is the final major area for financial transactions. Most of it can operate on profit-sharing basis, but there, would be an area where government would have to render certain _ services to the society and economy irrespective of the profitability. In the same way the central bank would

also have to operate not merely as a profit earner, but also as the guardian of the financial system. New instruments can be developed to regulate financial activity within the country and the relationship between the central bank and the commercial bank: In this respect also many valuable contributions have been made in recent literature.

- XII.** Insurance institutions in the contemporary world are operating on three principles which are at variance with basic Islamic values. They are interest, maisar (gambling) and garar risk). In life insurance the law of inheritance is also, violated. Islam disapproves of these. But it is possible to develop an alternate insurance system on the basis of mutual co-operation and equitable sharing of risks. A number of experiments were made by Muslims during the Muslim history and some contemporary companies' have started work on the principles of Takaful that is mutual support and solidarity. This is an alternate basis on which insurance in different areas can be developed. While the prospects for developing an alternate system of banking and insurance are very promising, the challenge is also extremely great. The proof of the Muslim claim would lie in the actual performance- of the alternate institutions Muslims should strive to establish.
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