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By *Pejman Abedifar*

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WP N° 16-002

1st Quarter 2016



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The Doctrine of *Riba* in the Contemporary World: Is Islamic Finance the Answer?

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This Draft: November 14, 2015

Abstract. This paper re-examines the doctrine of *Riba* and attempts to reconcile it with the contemporary world. I argue that conventional banking and finance practised in formal markets is not against Islamic principles so long as it operates on the basis of justice and does not treat the poor and the needy in an opportunistic manner. The doctrines of *Riba* and *Infaq* (charity) are inextricably linked and must therefore be considered together. The latter emphasizes helping the poor and the former prevents extracting rent from their need. Interest-based lending was merely an instance in the medieval era, and the exploitation of the poor can occur in different forms within different landscapes.

JEL Classifications: G00, G21, P00, Z12

Keywords: Islamic Finance, Riba, Infaq, Religion, Economic System

Acknowledgement: I would like to gratefully thank Philip Molyneux for his helpful comments on the paper. Any remaining errors are due to my negligence.

1. Introduction

Since its modern inception in 1975, Islamic finance has evolved and grown rapidly all over the world. It has been experiencing double-digit growth over recent years (The Banker, 2013; Islamic Financial Services Board, 2015). Assets managed under Islamic finance are estimated to exceed \$1.9 trillion in 2014 (Islamic Financial Services Board, 2015). Academia has extensively addressed this phenomenon¹ and examined different features of *Sharia*-compliant modes of finance based on Islamic scholars' interpretation of religious sources and modern finance. This paper attempts to re-examine such perceptions and reconcile Islamic principles with modern economic systems.

Devout Muslims and religious people in general face a dilemma in their daily life: they must fulfil the will of God revealed many centuries ago in their contemporary lives with completely different landscapes. One of the dilemmas relates to the prohibition of *Riba* (as the payment or receipt of *Riba* is regarded as one of the worst sins in the holy Qur'an), whereas technological advances and development of conventional financial systems necessitate engaging with financial transactions. Nowadays on the one hand, people live individually in big cities, rather than being clan members in small communities; on the other hand, exploiting economies of scale requires huge savings, mobilization and asset allocation at a relatively long distance. This dictates the establishment of a formal financial system operating on an impersonal basis to cope with the associated asymmetric information problems (moral hazard and adverse selection) linked to financial intermediation in the contemporary world.

To address the increasingly important necessity of formal financial service providers, Islamic scholars invented a new form of finance and banking on the basis of Islamic rules on transactions, *Figh al-Muamalat*, which in their opinion complies with Islamic principles and

¹ Please refer to Abedifar et al. (2015a) for overview of empirical studies on Islamic finance.

rules (*Sharia*), specifically the illicitness of *Riba*. In fact they have not established a mechanism for effecting the doctrine of *Riba*, instead they have attempted to make the contemporary finance and banking legitimate for Muslims. As such, although the holy Qur'an contrasts *Riba* and *Infaq* (charity), they have merely focused on how to avoid *Riba* without paying enough attention to the emphasis on *Infaq* and helping the poor and the needy.

Islamic finance has promoted financial inclusion, because many Muslims prefer financial products and services that comply with their religious belief (Frankfurt School of Finance and Management, 2006; C.G.A.P., 2008; Abedifar, et al. 2015b). However, and despite its fast growth during the last decade, it has been criticized by several scholars (El-Gamal 2006; Hamoudi, 2007 among others), as a method to circumvent the prohibition of *Riba*, seeking the same objective as conventional finance. I share this view and argue that this is because Islamic jurists have adopted a purely formalistic approach for fulfilling the will of God and have regarded the holy Qur'an as a law textbook. Treatment of default penalty is an excellent example of this formalistic approach. While almost all Islamic jurists agree that it is illicit as an "obvious" *Riba*, Islamic banks attempt to take it in one way or another. Increasing the mark-up rate at the first instance and giving the excess back in case of timely repayment is one of the popular methods for bypassing the prohibition.

Islamic banking and finance have almost similar objectives as their conventional counterparts do, but they follow different formalities to achieve their goals. The main question is, then, whether devout Muslims must carry out their financial transactions in a weird form and under complicated mechanisms to show that they obey the will of God. This paper attempts to shed light on this issue and explore how we can fulfil the doctrine of *Riba* in the contemporary world.

The review of the holy Qur'an shows that it condemns *Riba* but encourages *Infaq* instead. However, these can only be two sides of one coin. Believers must treat the poor and the needy as an instance for charity rather than an opportunity for making profit from their needs. The mainstream perceptions of Islamic jurists of different schools of thought suggest that classification of some types of trades as *Riba* by the Prophet Muhammad (P.B.U.H.) was probably a prophylactic rule to prevent circumventing the prohibition of *Riba*. In my opinion, however, Islamic scholars merely focus on formalistically observing the Prophetic injunction against *Riba* in trade and have used the same mechanism to design Islamic finance; whereas the main objective of the doctrine of *Riba*, which is helping the poor and treating them on the basis of justice has been thoroughly neglected.

This paper also examines the criticisms brought up by proponents of Islamic banking and finance against conventional finance and claims that they are invalid or not applicable. Yet conventional banking and finance practised in formal financial systems is not against the doctrine of *Riba* so long as it is fulfilled on the basis of justice and does not consider the poor and the needy as a profit-making opportunity. However, in informal financial markets and among individuals with more or less complete information about each other, e.g. in society with relatively lower level of individualism², equity contracts can better serve the purpose of justice. The doctrine of *Riba* is broader than lending, and must be considered together with the doctrine of *Infaq* in one package. The latter encourages helping the poor, and the former bans expropriating them. Interest-based lending was merely an instance in the medieval era, so it should be possible to set up a framework for fulfilling the doctrines of *Riba* and *Infaq* in a modern economic setting. The first step is to establish an efficient social security system by a

² Please refer to Hofstede (2001) for overview of cultural dimensions theory.

transparent, efficient and accountable government in order to provide the poor and the needy with equal rights and the necessity to flourish.

The remainder of the paper is organized as follows. Section 2 elaborates the doctrine of *Riba*, section 3 describes *Riba* in commercial lending, section 4 presents the mainstream Islamic scholars' perception, section 5 discusses the criticisms of the mainstream Islamic finance, section 6 examines fallacies of *Riba* in commercial lending, and section 7 proposes implications for the doctrine of *Riba* in the contemporary world. Finally, section 8 concludes.

2. The Doctrine of *Riba*

2.1. BACKGROUND

The history of interest-based lending can be traced back to 5000 BC, as a common practice in prehistoric society (Johnson, 2009). Abrahamic religions, however, forbid interest on loans and encourage people to lend to each other free of charge. “*Ribbit*”, “*Usury*” and “*Riba*” are the corresponding terms in Judaism, Christianity and Islam, respectively. In Modern Hebrew taking *Ribbit* is one of the worst sins³. The motivation for the strong prohibition of interest is to prevent the oppression of the poor and exploiting them because of their needs. As such, even Exodus prohibits certain items, e.g. garment, as a security for loans (Black et al. 1962). To fulfil the requirement of the Jewish law (“*Halacha*”) and avoid interest lending, Jewish jurists (“*Rabbis*”) recommend partnership agreements (“*Heter Ishka*”) where one party provides funds and the other provides entrepreneurial skills⁴. Moreover, interest-free loans (“*Gemach*”) are encouraged and established⁵. A number of jurists exclude conventional banking as a necessity for

³ Holy Hebrew Bible, Exodus, 22:24, Leviticus 25:36-37 and Deuteronomy, 23:20-21.

⁴ <http://www.jlaw.com/Articles/heter1.html>.

⁵ For information about the mechanism please refer to: <http://www.freeloan.org>

economic activities from the doctrine of *Ribbit*; nevertheless, they advise individuals and households to consider banks as the lender of last resort⁶.

Usury in lending was initially prohibited among Christians⁷; however, later on in the confrontation of the scriptural induction and the necessity of finance, the former was set aside and *Usury* became lawful (Eisenstein, 2011). For instance King Henry VIII of England in 1545 made *Usury* legal by decreeing a paradoxical act called “*the Act Against Usury*”. Martin Luther and John Calvin, the leading Protestant reformers, in the sixteenth century legitimated low-rate (4-5%) *Usury* (Graeber, 2011; Homer, 2005). In Roman Catholicism, Pope Pius VIII, the Inquisition of Rome, weakened the ban on *Usury* in 1830 by decreeing that confessors should no longer disturb those who lent at legal interest rates, e.g. 5% in France (Levillain, 2002). Eventually, in 1917, the Code of Canon Law allowed churches to make interest-bearing investments at the legal rate (Bouscaren and Ellis, 1957).

Islamic jurists adopted a different strategy to confront the dilemma. They designed a mechanism called “Islamic finance” to address both the doctrine of *Riba* and the need for finance which is the focus of this paper.

2.2. RIBA VERSUS *INFAQ* (RIBA IN LENDING)

In the holy Qur’an there is a considerable emphasis on helping the poor and the needy in different forms of charity, *Zakat* and *Qard al-Hasan* (collectively called “*Infaq*”). In fact, *Infaq* is one of the main pillars of Islam and the most important duty of Muslims after prayer

⁶ <http://connection.ebscohost.com/c/articles/90536401/rabbi-ariel-banks-are-last-place-borrow-money-from>

⁷ Sir Harry Page ‘In Restraint of Usury: The Lending of Money at Interest’ Chartered Institute for Public Finances and Accounts (CIPFA), London, 1985.

("Salaat")⁸. The holy Qur'an encourages Muslims to *Infaq* and emphasizes that helping the poor for the sake of God is highly valued and is a pre-requisite for attaining righteousness (e.g. chapter 3, verse 92; chapter 2:177). Appendix (1) provides a number of such verses. Knowing that it is difficult for human beings to sacrifice their own utility for the sake of others, God inspires believers to take part in *Infaq* in one way or another, e.g. purify your properties by *Infaq* (chapter 9:103); God will reward you (chapter 2:262, 272, 274; chapter 57:7; chapter 73:20); He would multiply the reward (chapter 2:245, 261; chapter 64:17); the reward will not perish (chapter 35:29); *Infaq* will keep you away from Hell (chapter 70:15-25).

In this context, a person who considers the financial need of the poor as a profit-making lending opportunity rather than a religious obligation indeed attempts to enervate the order of God and discourage believers from observing one of the main principles of Islam. As such, the holy Qur'an considers taking *Riba* as one of the worst sins and establishing a war against God and His Prophet (chapter 2:279). Appendix (2) highlights a number of the holy Qur'an's verses which condemn *Riba*. In chapter 3, verses 130-134, believers are advised not to take *Riba* to avoid Hell, whereas paradise is promised to those who obey God and His Messenger and help the poor. The verse 39 of chapter 30 points out that *Infaq* contrary to *Riba* will be increased and multiplied by God.

In chapter 2 also, *Riba* is discussed against charity (i.e. verses 261-274 elaborate the importance of charity and verses 275-280 condemn *Riba*). God will prosper from charitable deeds and will not bless *Riba* (verse 276). Believers are encouraged to donate as one of the criteria for obtaining the blessing of God (verse 277). Believers must not take *Riba*, otherwise they will be at war with God and the Messenger (verses 278 and 279). Those who stop taking

⁸ In at least 27 verses, *Infaq* follows *Salaat*: Chapter 2: verses 3, 43, 83, 110, 177, 277; chapter 4:77, 162; chapter 5:12, 55; chapter 8:3; chapter 9:5, 11, 18, 54, 71; chapter 13:22; chapter 19:31, 55; chapter 21:73; chapter 22:35, 41, 78; chapter 24:37, 56; chapter 35:29; chapter 42:38.

Riba will be treated fairly; they would have their capital; neither they nor debtors will suffer loss (verse 279). If borrowers cannot repay on time, lenders must give them time and it would be better if lenders forgave debt (verse 280).

In the verse 275 of chapter 2, the flawed argument of those who take *Riba* has been raised: they (mistakenly) claim that “trade is the same as *Riba*”. Indeed, similar to businessmen who seek to make profit, they spot an opportunity in the need of the poor and desire to expropriate some rent from them; whereas the holy Qur’an emphasizes that believers should treat the need of the poor as an opportunity for *Infaq*. Hence, while trading is allowed, *Riba* is forbidden. In other words, believers must forgo *Riba* and donate instead; they must stop taking *Riba* to save themselves from punishment on the Day of Judgment, and reward will be given to those who help the poor.

2.3. RIBA IN TRADE

Riba in the holy Qur’an is prohibited in connection with settlement of debts and lending. However, in *Hadiths*⁹, the same terminology is used to elaborate some *Haram* (forbidden by *Sharia*) terms in business. In this section, I review definition of *Riba* in trade under major Islamic schools¹⁰:

⁹ A *Hadith* (Prophet Muhammad’s saying) can be considered binding if it is not in contrary with the holy Qur’an, being authentic (*Sahih*) in a sense that all the chains (reporters) identified as honest narrators, being explicit and clear. Moreover, for fundamental issues a *Hadith* must be reported through different channels (*Mutawatir*) (Shahid Thani, 1558; Farooq, 2009).

¹⁰ There are four main *Sunni* schools, i.e. *Hanafi*, *Shafi’i*, *Malikis* and *Hanbali*, and one main *Shia* school, i.e. *Twelver Shia*. *Sunni* Muslims consider the wording of the companion as the channel to *Sunnat* (Prophet Muhammad’s utterance and way of life) as the second source - alongside of the holy Qur’an – for religious thought and guidelines, whereas *Shia* Muslims consider the narration of Ali ibn Abi Talib (the Prophet’s cousin and son-in-law) and his sons as the route (Tabatabai, 1979).

2.3.a. SUNNI SCHOOLS OF THOUGHT

According to *Sunni* jurists we have two types of *Riba* in trade:

2.3.a.i. *Riba of Excess (Riba Al-Fadl)*

Riba of excess occurs in spot transactions when a product is exchanged for the same type of product but with different quantity (Ibn Rushd, 1997), e.g. one kilogram of high quality dates against three kilograms of low quality ones. It is forbidden by major *Sunni* schools of jurisprudence on the basis of a *Hadith* attributed to the Prophet Muhammad. The *Hanafi* jurists believe that *Riba of excess* is applicable to items sold by either weight or volume (Saleh, 1986; Ibn Rushd, 1997). The *Shafi* School considers all types of food, gold and silver as the purpose of this rule (Saleh, 1986; Ibn Rushd, 1997). The *Malikis* limit the rule to only non-perishable basic foods, gold and silver (Saleh, 1986).

The main rationale is preventing circumvention of the prohibition of *Riba*, i.e. it is prohibited as a means to an end (Rdia, 1970; Al-Zuhayli, 2003). Ibn Qayyim al-Jawziyya calls this type of *Riba* as “subtle” *Riba* that is prohibited because it can lead to “obvious” *Riba* (Al-Sanhuri, 1953). Market supervision, transparency and stability for fair distribution of goods and avoiding injustice and mispriced transactions are some other explanations for this rule taking into account the scarcity and importance of some of the goods in the era of the Prophet (Ibn Rushd, 1997; Al-Humam, 2004; El-Gamal, 2006; Fadel, 2008).

2.3.a.ii. *Riba of Delay (Riba Al-Nasi'ah)*

Riba of delay occurs in deferred transactions when certain commodities are exchanged for the same type of products even if the counter-values are the same, e.g. trading one kilogram of gold for one kilogram of gold to be exchanged some time in future. It is forbidden by major *Sunni* Islamic schools on the basis of a *Hadith* attributed to the Prophet Muhammad. According to *Malikis* and *Shafi'is*, deferred trade of foodstuffs and also gold and silver is prohibited by the

principle of *Riba of delay*. The deferred trade of other commodities is allowed under certain conditions. For the *Hanafis*, deferred transactions of commodities sold by weight or volume is allowed if they are traded against gold, silver, copper coins or a good not sold by volume or weight (Saleh, 1986)¹¹.

A few jurists (e.g. Ibn Qayyim al-Jawziyya and Ibn Rushd) believe that *Riba of delay* is prohibited as “obvious” *Riba* (Al-Sanhuri, 1953); whereas others (e.g. Rida) believe that the prohibition has been taken place as a prophylactic rule and classify *Riba of delay* as “subtle” *Riba*. Al-Zuhayli (2003) believes that *Riba of delay* is prohibited to avoid exploitation of the needy by the rich and (food) market instability. Al-Sanhuri (1953) claims that similar to *Riba of excess*, *Riba of delay* is not explicitly mentioned in the holy Qur’an (contrary to *pre-Islamic Riba*¹²) and hence we should treat both in a similar manner. He also proposes the same rationale for prohibition of both *Riba of excess* and *Riba of delay* (i.e. to avoid mispriced transactions and market instability) and classify them as “subtle” *Riba*. *Hanbali* School also considers the *pre-Islamic Riba* as the only “obvious” *Riba* (Ibn Qayyim al-Jawziyyah, 1973). Regarding *Riba of excess* and *Riba of delay*, however, different views have been attributed to *Hanbali* school of thought. The first view is close to *Hanafis*, while the second view is similar to *Shafi’is* and *Malikis* (Obaidullah, 1999).

El-Gamal (2006) argues that the policy objective of this rule is to avoid unbundled sale of credit, because the prohibition requires that credit be granted for the purchase of a specific asset, and traders must establish the interest rate on the basis of the future value of the underlying assets. Fadel (2008) casts doubt on the price-setting policy of both *Riba of excess* and *Riba of*

¹¹ Please refer to Fadel (2008) for a detailed discussion on *Riba of excess* and *Riba of delay*.

¹² During the pre-Islamic period, it was a common practice to demand for an increase if debtors were not able to pay their debt to creditors on maturity date. In such circumstances, the repayment had been deferred by creditors conditional on an increase on debt. This type of *Riba* is also called “obvious” *Riba*.

delay because the prohibition can be bypassed through engaging in two trades instead of one. He argues that existing Islamic law cannot provide a convincing argument for prohibition of these two types of *Riba*. He claims that the overlap between the goods that are subject to both *Zakat* and *Riba* (*Riba of excess and delay*) suggests that the policy objective is price-setting and is relevant in tough economic times to protect consumers under the wealth-redistribution system of *Zakat*.

2.3.b. SHIA SCHOOL OF THOUGHT

Shia jurists define one type of *Riba* in trade called '*Riba in Exchange*' or '*Riba Moameli*'. It occurs in transactions when a product is exchanged for the same type of product but with different quantity, e.g. one kilogram of high quality dates against three kilograms of low quality one. It is forbidden by major *Shia* jurists. The prohibition is only applicable to goods that are traded by either weight or volume. It is classified as "*subtle*" *Riba* and the prohibition is made as a preventative measure (Bojnordi, 2010).

3. *Riba* in Commercial Lending

The Islamic terminology for lending is *Qard* (or *Qard Al-Hasan*). The exegesis of the holy Qur'an suggests that *Qard* has a charitable nature (chapter 2:280). As such, the person making a *Qard* cannot expect any benefit or excess from the receiver of the *Qard*. Moreover, late repayment penalties cannot be enforced. Because of its charitable nature, *Qard* is excluded from the rule of *Riba of delay*, although it embeds a deferred settlement. *Qard* with interest loses its charitable nature and hence is considered *Haram* by the *Sunni* doctrine of *Riba of delay*. It is also prohibited according to the *Shia* school of thought on the basis of the charitable nature of *Qard*.

The majority of Islamic jurists believe that interest in commercial lending or self-interest loans is also forbidden. A number of jurists classify this interest as a “subtle” *Riba* (Al-Kasani, 1997; Al-Shirbini, 1994), whereas others such as Al-Zuhayli and Abu Zahra (Al-Zuhayli, 2003; Abu Zahra, 1970) treat it as an “obvious” *Riba*. Both of these jurists argue that allowing interest in lending would change money into an object of commerce; whereas it is merely an instrument for measuring the value of commodities (Abu Zahra, 1970; Al-Zuhayli, 2003). Al-Sanhuri (1953) and Al-Zuhayli (2003) condemn commercial lending because they believe that it is unfair and propose a profit-loss sharing mode of finance.

There are a few jurists, however, who exempt this type of lending from the doctrine of *Riba*. Rashid Rida (1970) claims that only *pre-Islamic Riba* is prohibited for its own sake by the holy Qur’an¹³. He argues that interest on lending is an instance of *Riba of excess*, which is prohibited as a preventative device, even though the excess will be paid at the end of lending period. Among *Shia* jurists, Bojnordi (2010) and Saanei (2004) claim that commercial lending is not subject to the ban imposed by *Sharia*. They believe that the prohibition of *Riba in lending* is merely attributed to *Qard* to the poor and the needy.

4. Mainstream Islamic Scholars’ Perception

Interest-bearing lending is prohibited by the doctrine of *Riba*; however, credit sales are allowed by major Islamic schools¹⁴ (Saleh, 1986; Al-Zuhayli, 2003; Bojnordi, 2010). One can sell a product on credit at a higher price by incorporating the time value of money (interest). As such, to avoid *Riba* and fulfil the requirements of *Sharia*, Islamic scholars initiate the so-called

¹³ Al-Sanhuri (1953) shares the same view as of Rashid Rida that *pre-Islamic Riba* is the only form of “obvious” *Riba*.

¹⁴ The majority of *Shia* jurists have even authorized discounting deferred payment bills if they are based on a commercial transaction (Bojnordi, 2010).

“Islamic finance” on the basis of the Islamic rules on transactions, *Figh al-Muamalat*, wherein Islamic financiers play the role of a trader or an investor in lieu of a lender¹⁵. For instance, a *Murabaha* contract is designed based on credit trade, and used by Islamic financiers for provision of *Sharia*-compliant financial services, by purchasing the goods to be financed on sight basis and then reselling them on credit at a higher price to their clients.

Since default penalties are forbidden by major jurists, Islamic financiers use rebates to encourage their clients for timely payment (Khan and Ahmed, 2001). They embed an excess to the credit sale price which will be paid back to clients if they fulfil their payment commitment on time. In some countries such as Pakistan, the default penalty is allowed, only if it is spent on charity (Baele et al., 2014). In Iran, in order to collect default penalties, a covenant is added to Islamic finance contracts that commits clients (borrowers) to remunerate financiers for a pre-specified damage/loss to be incurred by financiers due to clients’ non-fulfilment of payment commitment on due dates (Bojnordi, 2003).

5. Criticisms of Mainstream Islamic Finance

Several scholars believe that functionally there is little difference between Islamic and conventional financial products; Islamic banks are merely mimicking conventional banks (Kuran, 1993, 2004; El-Gamal, 2006; Hamoudi, 2007; Khan, 2010). Kuran (1993) associates the similarity of the two systems to the fact that both are practised in an asymmetric information environment. As such, Islamic banks have no choice but to follow the same techniques and principles that are adopted by conventional banks.

¹⁵ Please refer to El-Gamal (2006) for structure and mechanism of Islamic finance products.

El-Gamal (2006) argues that Islamic finance suffers from economic inefficiency because of its higher transaction costs¹⁶ and provides little economic value. He attributes this problem to juristic inferences of major *Sunni* scholars which is based on reasoning by analogy¹⁷. He points out that we should focus more on the substance and spirit of Islamic law which in his opinion is avoiding excessive indebtedness and risk taking. He further claims that we should stick to forms, though they are inefficient, to ensure adherence to religion, and at the same time and more importantly, follow the economic substance of Islamic law. However, Hamoudi (2007) argues that a formalist approach, which is applicable in particular religious rituals, cannot be used in finance, because finance has a functional nature and financial institutions have emerged for functional reasons, and approaching them in a highly formalist manner seems meaningless. He puts forth the case of *Murabaha* and points out that it can be easily manipulated to function exactly the same as interest-based loans¹⁸.

Khan (2010) argues that after three decades from its inception, Islamic banking and finance is functionally very similar to conventional banking despite its advocates claiming that Islamic finance will distinguish itself by stronger promotion of justice and wealth equality (Chapra, 1985; Usmani, 1998). Overall, many scholars (Vogel and Hayes, 1998; Fadel, 2008) do not find the theories put forward to explain the orthodoxy of *Riba* convincing.

There is a general consensus among Islamic jurists that default penalties are an “obvious” *Riba*; however, the way it is treated under Islamic finance and banking shows how formalistic the existing approach is. The other example is the relationship between Islamic banks and their

¹⁶ A number of studies claim that Sharia-compliant financial products and services are more expensive than conventional ones (e.g. Baele et al, 2014).

¹⁷ He believes that although *Shia* school allows its jurists to use different means of judicial inference such as reason (*Aql*), the principle of caution (*Ihtiat*) has tempted the accorded freedom. Moreover, *Shia*-dominated countries has extrapolated Islamic finance from *Sunnis*.

¹⁸ Recently such manipulation is practiced by some practitioners under the name of *Tawarruq* or *Reverse Murabaha*; according to El-Gamal (2006) only some jurists from *Hanbali* School have validated its legitimacy.

depositors. Financial securities are defined by the rights that they create for their owners: shares entitle their owners to vote for the firm's management, whereas debt securities give the right to seize and liquidate collateral in case of the firm's failure to make fixed promised payments (Hart, 1995; La Port, et al, 1998).

Islamic banking theory claims that realized profit or loss must be shared between Islamic banks and depositors, which suggests an equity nature; however, contrary to equity securities, depositors of Islamic banks are not given the voice to exert corporate control; rather, similar to depositors of conventional banks, they can only vote with their feet. In practice, Islamic banks pay a market rate of return to their depositors irrespective of the actual outcome to avoid runs on the bank (Obaidullah, 2005). Chong and Liu (2009) show that in Malaysia the rate of returns to Islamic banks' depositors are pegged to conventional banks' deposit rates. Hence, deposits in Islamic banking serve the same function as deposits of conventional banks, but with a different form.

Islamic banks finance their clients using trade transactions. For instance, in *Murabah*, Islamic banks purchase the underlying goods on the spot and then resell them at a higher price to their clients. For the purchase of the goods, they normally give agency to their clients in order to avoid a real trade. Since ownership carries its specific risks, clients are required to foresee necessary arrangements to avoid any loss to Islamic banks. This framework follows the objective of a simple loan contract in conventional finance, but through a more complicated procedure. Is complexity the major objective of the doctrine of *Riba*?

6. Fallacies of *Riba* in Commercial Lending

The majority of jurists believe that restriction of *Riba* in lending also includes lending for business and investment purposes. In this section we examine the rationale set forth by them:

6.1. *RIBA* IN LENDING IS INJUSTICE

A number of Islamic jurists (Al-Sanhuri, 1953 and Al-Zuhayli, 2003 among others) believe that taking *Riba* in lending in any form is injustice and oppression of borrowers, because they have to repay debt irrespective of their earnings. For instance, Abu Zahra (1970) and Al-Zuhayli (2003) condemn interest-based lending for not sharing the possible incurred loss with entrepreneurs and suggest equity and partnership contracts for financing.

Riba in lending during the medieval era could be oppressive for borrowers, as at that time lenders were wealthy and had more bargaining power compared to those borrowers who were poor and needy. Contemporary financial systems, however, have evolved to mobilize small savings to meet the financing needs of entrepreneurs who are generally wealthier than savers, because modern theory of finance suggests that borrowers must have adequate wealth to convince lenders that they have enough incentive to exert effort and properly implement the underlying projects (Stiglitz and Weiss, 1981; Tirole, 2006). Moreover, as of the 1920s borrowers are protected by limited liability and, in the case of default, there are no (or at least limited) non-pecuniary penalties such as physical penalties or jail like what was practised in ancient history (Diamond, 1996). Moreover, in many countries, interest stops accruing from the time bankruptcy is filed (for instance Chapter 11 U.S.C. § 502(b) (2006) in the U.S.).

In a perfect market condition which is described by Modigliani and Miller (1958), i.e. a world without asymmetric information problems, profit and loss sharing is the best choice and serves the purpose of fairness. In the real world, people may use equity contracts in informal markets so long as they know each other very well; however, in the formal financial system there is the possibility of friction. As such, when the revenue of an underlying project is not easily verifiable, debt is the optimal contract (Townsend, 1979; Gale and Hellwig, 1985). Banks can

use monitored debt contracts in order to avoid costly and inefficient liquidation and examine the cash flow of the financed project in the downside scenario (Diamond, 1984). From the borrower's point of view, Myers and Majlounf (1984) show that with the presence of information asymmetry, equity finance is the most expensive and hence least favourable source of funding.

It is interesting to note that even Islamic banks use mainly debt and lease base contracts rather than profit and loss sharing (Mills and Presley, 1999; Aggarwal and Yousef, 2000; Dar and Presley; 2000; Chong and Liu; 2009)¹⁹. This is in line with the idea of Kuran (1993) that Islamic banks follow the techniques adopted by conventional banks, because they also operate in an asymmetric information environment. In a *Hadith* attributed to Musa al-Kadhim, the 7th Imam of Twelver Shia, commercial lending is classified as *Riba* (Al-Hurr Al-Amili, 1693). The prohibition is valid in that era because entrepreneurs were not protected by limited liability, and there were no supportive laws for bankrupt firms; moreover, individuals made their investment decisions in an informal financial market with enough information from their counterparts.

It can be seen that the context within which the prohibition of *Riba* was initially introduced has been thoroughly changed during recent centuries. Now lending can even lead to the oppression of lenders; Jensen and Meckling (1976) show that debt in capital structure creates incentives for moral hazard problem, because managers -acting on behalf of equity holders- may follow risky projects at the cost of debt-holders. Finally, within Islamic modes of finance, both debt-based and profit and loss sharing models are valid, and no preference has been reported by pre-modern Islamic law (Fadel, 2007).

It can be posited that interest in commercial lending should not be considered as illicit, so long as it does not breach the justice pillar of Islam. As such, payday lending, for instance, treats

¹⁹ Abedifar et al. (2013) elaborate how Islamic banks deviate from the principle in practice and mimic conventional banking.

the needy people in an opportunistic manner and can be considered as the subject of the doctrine of *Riba*, because borrowers are in need of a very small loan and pay relatively a high interest rate. In Colorado for instance, the payday loans originated between July 2000 and December 2008 on average are \$300 in value, bear \$55 charge at annual interest rate of 452% for a period of 17 days and renewed several times (DeYoung and Phillips, 2009).

The other argument raised by a few jurists is that interest-based lending put capital in a better position than labour. For instance, Abu Zahra (1970) claims (as quoted in Fadel, 2008): “*the spread of lending at interest is nothing other than the severe tyranny of capital over labour and all other means of production*”. This argument is not valid, because within Islamic modes of finance, *Mudarabah* is a form of contract under which a party provides capital to the entrepreneur and the return would be shared between the two parties. Entering into this contract in lieu of debt does not guarantee a fair treatment of capital versus labour because, for instance in economies with under-developed financial systems and scarcity of capital, an investor can claim a higher proportion of profit, or demand the full return of her capital before any payoff to the entrepreneur.

6.2. PROHIBITION OF *RIBA* IN THE HOLY QUR’AN IS GENERIC

The holy Qur’an does not explicitly mention which type of *Riba* is forbidden and whether commercial lending is excluded from the prohibition. Nevertheless, we can investigate whether the doctrine of *Riba* is applicable to commercial lending by examining the context within which the prohibition is imposed and the addressees of the verses. Since *Riba* is put forward against *Infaq*, I argue that the main idea is protecting the needy from expropriation. Moreover, during the era of the Prophet, contemporary financial systems had not emerged and borrowing was mainly

for procurement of the necessities of life. Overall, it seems too difficult to claim that commercial lending is subject to the doctrine of *Riba*.

6.3. RIBA IN COMMERCIAL LENDING MUST BE FORBIDDEN AS A PROPHYLACTIC RULE

Another argument is that because of its resemblance to *Qard* (*Qard Al-Hasan*), *Riba* in commercial lending is prohibited, since the popularity of this type of *Riba* discourages Muslims from charity and granting *Qard Al-Hasan*. For instance, Abu Zahra (1970) claims (as quoted in Fadel, 2008): “*the proliferation of lending at interest has encouraged many to become extravagant and neglect to save*”. This argument may be valid and true; however, the existing Islamic finance cannot be a solution as it suffers from the same criticism. Prohibition as a prophylactic rule is not relevant in the contemporary world with developed financial systems, because there are so many alternatives for investment.

6.4. RIBA IN COMMERCIAL LENDING IS FORBIDDEN BECAUSE MONEY DOES NOT HAVE ANY INTRINSIC VALUE

In response to critics of mainstream Islamic finance and its resemblance in function to conventional finance, e.g. the case of *Murabaha*²⁰, several Islamic jurists (Abu Zahra, 1970; Al-Zuhayli, 2003 among others) argue that *Riba* in lending is essentially unlawful, because money does not have any intrinsic value and is merely an instrument to measure value. For instance, Abu Zahra (1970) claims (as quoted in Fadel, 2008): “*Currencies are the means of valuation, so time by hypothesis does not affect them*”. This argument is not true, because money by definition

²⁰ If *Riba* in lending is injustice, then credit sale of a commodity at a higher price (with mark-up) that reflects an excess similar to interest in lending must be also considered unfair.

also serves as a means for storing purchasing power; hence, one is ready to pay to avail herself with purchasing power.

7. Implications of the Doctrine of Riba in the Contemporary World

I argue that the prohibition of *Riba* does not imply the illegitimacy of conventional banking and finance. This raises an important question as to whether the doctrine of *Riba* is applicable in the contemporary world, and if so how it should be enforced. The doctrine of *Riba* attempts to prevent the oppression of the poor and exploitation of the needy, and interest-based lending was just an instance in the medieval era. Moreover, it complements the emphasis on helping the poor prescribed by the doctrine of *Infaq*.

Implication of the doctrines of *Riba* and *Infaq* need to be revisited by paying sufficient attention towards the features of the contemporary world. For instance, in the U.S., still the strongest country in the world, a relatively low tax (and a modest social security) system has been adopted. Nevertheless, loan takers benefit from the tax shield thanks to the discrimination imposed by the classical tax system. Moreover, to maximize exploitation of the tax shield, financial intermediaries are subject merely to a very small capital requirement and at the end they receive bailouts at the time of crisis (Admati, et al., 2013). The poor and the middle class households are systematically oppressed under this system as it allows high net worth individuals to appropriate a considerable proportion of the public funds and can be regarded as one of the instances of the doctrine of *Riba* in the contemporary world. I propose the following agenda to observe the scriptural induction:

The first step is establishing a well-functioning and efficient social security system in order to provide the poor and low income households with equal opportunity for education, health and any other basic necessities to flourish. The existing policy of Scandinavian countries

could be a good instance to start with. However, this requires levying relatively high taxation, which leads to the trade-off between social welfare and efficiency loss due to a state's wealth-redistribution-system. As such, the pre-requisite for enforcing the doctrines of *Riba* and *Infaq* is having a transparent, efficient and accountable government.

The classical tax system discriminates between debt and equity; it rewards those who benefit from leverage with tax relief. This subsidy can exacerbate fragility of financial systems, and ultimately create negative externalities, by encouraging excessive indebtedness. The second step is, therefore, revisiting the tax system with the objective of fair treatment of debt and equity funding as suggested by Boadway and Bruce (1984) and Devereux and Freeman (1991). This is particularly important for those who may believe that debt contracts are unfair. Furthermore, Piketty (2014) points out that increasing income inequalities can be partly explained by the fact that wealth can grow at a higher rate than overall output and wages for a long period of time. As such, he proposes a progressive tax on capital, under close international cooperation and regional integration, to contain inequalities of wealth.

In many developing countries scarcity of credits place the owners of wealth in a better position for negotiation with entrepreneurs and labour. An efficient financial system prevents the tyranny of pecuniary wealth on ideas and labour. The third step is then promoting financial development such that savings are efficiently mobilized and allocated to the most promising projects (as prescribed for economic development by several economists such as Schumpeter, 1912 and Hicks, 1969) and also so that financial exclusion reaches its minimum level. Financial development, however, requires revisiting legal systems with the objective of having clear, fair and supportive rules and an efficient enforcement process (La Porta et al. 2000). Moreover, we should prudently supervise and regulate financial deepening, as it can ease expropriation of low or middle class people either in the form of squandering the public funds due to adopting a lax

lending policy as occurred during the 2004-06 period preceding the credit crunch 2007-08 (The Financial Crisis Inquiry Report, 2011) or oppressing consumers through making them excessively indebted with the objective of stimulating the demand side without increasing households income. Barba and Pivetti (2009) study the U.S. economy over the 1980-2005 period, the time span with a substantial increase in income inequality, and conclude that household debt is principally used as a substitute for increase in wages and public expenditure. Hyman (2011) argues that in the post-Bretton Woods era, due to abundant liquidity and asset-price appreciation, increase in wage is replaced by expansion of consumer credits resulting in a significant rise in household's indebtedness. Hence consumer loans is no longer a personal choice, but a systematic necessity. Such an economic policy is possibly another instance of *Riba* in the modern World.

Education is the fourth step. Poverty can show up because of mismanagement or insufficient financial knowledge. In the case of payday loans, borrowers in the U.S. are eligible to receive such loans if they have a steady income and a bank account (DeYoung and Phillips, 2009); however, they often have small loans that are refinanced at excessive cost. There are also many examples of individuals losing their fortune because of investing in a single stock²¹. Hence, principles of finance can be taught at the school level to help households in their financial decision and wealth management. Finally, policy makers and activists should inspire financial and nonfinancial institutions with corporate social responsibility²². This can be helpful to encourage fair-mindedness in our society.

²¹ Based on personal experience as a broker in Tehran Stock Exchange during 1997-98, I observed that some investors lost most of their fortune because they invested heavily in a single stock that experienced sharp falls in price.

²² Thanks to emergence of responsible and ethical finance, now many Islamic financial institutions attempt to follow ethical finance as another aspect of Islamic finance.

8. Concluding Remarks

The belief generally accepted among Islamic jurists and scholars is that the holy Qur'an prohibits *Riba*, but it does not provide the exact definition. It merely contrasts *Riba* vis-à-vis *Infaq*. As such, religious scholars seek to find the definition in prophetic narration (Farooq, 2007, 2009; Thomas, 2006; Hamoudi, 2007). However, the majority of Islamic jurists believe that the prohibition of *Riba* in trade was enacted by the Prophet Muhammad as a prophylactic rule. In response to religious induction on the one hand and necessity of finance on the other hand, Islamic jurists initiated the so-called "Islamic finance" on the basis of Islamic rules on transactions, *Figh al-Muamalat*, which has received criticism from many scholars.

I share the idea with those who believe that Islamic jurists adopt a formalistic approach and Islamic finance serves no substantial end but to follow what its proponents believe to be the will of God. I argue that many jurists overlook the emphasis of God on forgoing the speculative view on the need of the poor, and in addition helping them as demanded by the doctrine of *Infaq*. They highlight trade against lending vis-à-vis *Riba* against *Infaq* and thereby they indeed unintentionally effectuate the claims of usurers that "*trading is only like usury*" (chapter 2:275), because they reshuffle the process of taking *Riba* and institutionalize it in trade in lieu of lending. In other words, they embed *Riba* in trade in an attempt for the omission of *Riba* in lending.

Apart from the literal approach which is well addressed by several scholars, I believe that the problem arises from the fact that Islamic jurists mainly consider the holy Qur'an as a law textbook; they attempt to make it possible for Muslims to carry out their activities without violating religious orders and, where necessary, use the loopholes and benefit from regulatory arbitrage. El-Gamal (2006) coins the term "*Sharia arbitrage*" to describe Islamic finance and urges paying sufficient attention to the spirit of Islamic law; nevertheless, in his book (page 50), he mentions that the doctrine of *Riba* cannot aim at preventing exploitation of the poor, because

“a usurer can equally easily exploit a needy debtor by selling him a property of market value \$100, say, for a deferred price of \$1,000, without violating the rules of *riba* as envisioned by jurists.” Such an approach towards religious texts results in the establishment of the so-called “Islamic finance” inspired by the Prophetic induction notwithstanding its preventative nature.

The holy Qur’an is a book for guidance towards human bliss, and its social inductions specifically must be considered and inferred with the view of the corresponding environment. As such, we should revisit implications of the scriptural induction based on the needs of the contemporary world, otherwise it is likely to be either set aside or bypassed. I further argue that we should invite economists to assist in designing an economic system under which the poor and the needy are treated on the basis of justice. We should have a different approach for non-worshipping wills of God -*Riba* in our case- as compared to devotional rituals such as prayer, fasting or pilgrimage; for the latter, we refer to definitions and details provided in Prophetic traditions and adhere to the forms; however, for the former, definition and solutions must be reached with the help of experts, e.g. economists in the case of *Riba*. We cannot establish special forms for finance and business to show our fidelity to our religion. This would merely complicate mechanisms and impose a dead-weight loss to our society.

Interest-bearing loans, were merely an instance of exploiting the needy in medieval times. The doctrine of *Riba* is broader than lending in the contemporary world. It attributes to general economic policy and can be considered alongside the doctrine of *Infaq*. I also suggest a framework to regulators and policy makers for fulfilling the doctrines of *Riba* and *Infaq*. Even though it can be argued that there is a general consensus on the proposed agenda and many of proponents of Islamic finance may believe in them, religion is, nevertheless, supposed to give an extra incentive for following policies that are conducive to more justice and kindness as prescribed by the holy Qur’an (chapter 16:90).

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APPENDIX 1. Infaq in the Holy Qur'an

Chapter 2, verse 110:

“And keep up prayer and pay the poor-rate and whatever good you send before for yourselves, you shall find it with Allah; surely Allah sees what you do.”²³

Chapter 2, verse 177:

“... but righteousness is this that one should believe in Allah and the last day and the angels and the Book and the prophets, and give away wealth out of love for Him to the near of kin and the orphans and the needy and the wayfarer and the beggars and for (the emancipation of) the captives, and keep up prayer and pay the poor-rate; and the performers of their promise when they make a promise, and the patient in distress and affliction and in time of conflicts-- these are they who are true (to themselves) and these are they who guard (against evil).”

Chapter 2, verse 215:

“They ask you as to what they should spend. Say: Whatever wealth you spend, it is for the parents and the near of kin and the orphans and the needy and the wayfarer, and whatever good you do, Allah surely knows it.”

Chapter 2, verse 219:

“... And they ask you as to what they should spend. Say: What you can spare. Thus does Allah make clear to you the communications, that you may ponder,”

Chapter 2, verse 245:

“Who is it that will offer of Allah a goodly gift, so He will multiply it to him manifold, and Allah straitens and amplifies, and you shall be returned to Him.”

Chapter 2, verses 261-274:

“The parable of those who spend their property in the way of Allah is as the parable of a grain growing seven ears (with) a hundred grains in every ear; and Allah multiplies for whom He pleases; and Allah is Ample-giving, Knowing (261) (As for) those who spend their property in the way of Allah, then do not follow up what they have spent with reproach or injury, they shall have their reward from their Lord, and they shall have no fear nor shall they grieve (262). Kind speech and forgiveness is better than charity followed by injury; and Allah is Self-sufficient, Forbearing (263). O you who believe! do not make your charity worthless by reproach and injury, like him who spends his property to be seen of men and does not believe in Allah and the last day; so his parable is as the parable of a smooth rock with earth upon it, then a heavy rain falls upon it, so it leaves it bare; they shall not be able to gain anything of what they have earned; and Allah does not guide the unbelieving people (264). And the parable of those who spend their property to seek the pleasure of Allah and for the certainty 'of their souls is as the parable of a garden on an elevated ground, upon which heavy rain falls so it brings forth its fruit twofold but if heavy rain does not fall upon it, then light rain (is sufficient); and Allah sees what you do

²³ I use exclusively the English translation of the Qur'an by Mr. Shakir (1866-1939).

(265). Does one of you like that he should have a garden of palms and vines with streams flowing beneath it; he has in it all kinds of fruits; and old age has overtaken him and he has weak offspring, when, (lo!) a whirlwind with fire in it smites it so it becomes blasted; thus Allah makes the communications clear to you, that you may reflect (266). O you who believe! spend (benevolently) of the good things that you earn and of what We have brought forth for you out of the earth, and do not aim at what is bad that you may spend (in alms) of it, while you would not take it yourselves unless you have its price lowered, and know that Allah is Self-sufficient, Praiseworthy (267). Shaitan threatens you with poverty and enjoins you to be niggardly, and Allah promises you forgiveness from Himself and abundance; and Allah is Ample-giving, Knowing (268). He grants wisdom to whom He pleases, and whoever is granted wisdom, he indeed is given a great good and none but men of understanding mind (269). And whatever alms you give or (whatever) vow you vow, surely Allah knows it; and the unjust shall have no helpers (270). If you give alms openly, it is well, and if you hide it and give it to the poor, it is better for you; and this will do away with some of your evil deeds; and Allah is aware of what you do (271). To make them walk in the right way is not incumbent on you, but Allah guides aright whom He pleases; and whatever good thing you spend, it is to your own good; and you do not spend but to seek Allah's pleasure; and whatever good things you spend shall be paid back to you in full, and you shall not be wronged (272). (Alms are) for the poor who are confined in the way of Allah-- they cannot go about in the land; the ignorant man thinks them to be rich on account of (their) abstaining (from begging); you can recognize them by their mark; they do not beg from men importunately; and whatever good thing you spend, surely Allah knows it (273). (As for) those who spend their property by night and by day, secretly and openly, they shall have their reward from their Lord and they shall have no fear, nor shall they grieve (274).”

Chapter 3, verse 92:

“By no means shall you attain to righteousness until you spend (benevolently) out of what you love; and whatever thing you spend, Allah surely knows it.”

Chapter 9, verse 60:

“Alms are only for the poor and the needy, and the officials (appointed) over them, and those whose hearts are made to incline (to truth) and the (ransoming of) captives and those in debts and in the way of Allah and the wayfarer; an ordinance from Allah; and Allah is knowing, Wise.”

Chapter 9, verse 103:

“Take alms out of their property, you would cleanse them and purify them thereby, and pray for them; surely your prayer is a relief to them; and Allah is Hearing, Knowing.”

Chapter 14, verse 31:

“Say to My servants who believe that they should keep up prayer and spend out of what We have given them secretly and openly before the coming of the day in which there shall be no bartering nor mutual befriending.”

Chapter 35, verse 29:

“Surely they who recite the Book of Allah and keep up prayer and spend out of what We have given them secretly and openly, hope for a gain which will not perish.”

Chapter 47, verse 38:

“Behold! you are those who are called upon to spend in Allah's way, but among you are those who are niggardly, and whoever is niggardly is niggardly against his own soul; and Allah is Self-sufficient and you have need (of Him), and if you turn back He will bring in your place another people, then they will not be like you.”

Chapter 57, verse 7:

“Believe in Allah and His Apostle, and spend out of what He has made you to be successors of; for those of you who believe and spend shall have a great reward.”

Chapter 63, verse 10:

“And spend out of what We have given you before death comes to one of you, so that he should say: My Lord! why didst Thou not respite me to a near term, so that I should have given alms and been of the doers of good deeds?”

Chapter 64, verses 15-17:

Your possessions and your children are only a trial, and Allah it is with Whom is a great reward (15) Therefore be careful of (your duty to) Allah as much as you can, and hear and obey and spend, it is better for your souls; and whoever is saved from the greediness of his soul, these it is that are the successful (16). If you set apart for Allah a goodly portion, He will double it for you and forgive you; and Allah is the Multiplier (of rewards), Forbearing (17),

Chapter 70, verses 15-25:

“By no means! Surely it is a flaming fire (15) Dragging by the head (16), It shall claim him who turned and fled (from truth) (17), And amasses (wealth) then shuts it up (18). Surely man is created of a hasty temperament (19) Being greatly grieved when evil afflicts him (20) And niggardly when good befalls him (21) Except those who pray (22), Those who are constant at their prayer (23) And those in whose wealth there is a fixed portion (24). For him who begs and for him who is denied (good) (25).”

Chapter 73, verse 20:

“...and keep up prayer and pay the poor-rate and offer to Allah a goodly gift, and whatever of good you send on beforehand for yourselves, you will find it with Allah; that is best and greatest in reward ...”

APPENDIX 2. Riba in the Holy Qur'an

Chapter 2, verses 275-280:

“Those who swallow down usury cannot arise except as one whom Shaitan has prostrated by (his) touch does rise. That is because they say, trading is only like usury; and Allah has allowed trading and forbidden usury. To whomsoever then the admonition has come from his Lord, then he desists, he shall have what has already passed, and his affair is in the hands of Allah; and whoever returns (to it)-- these are the inmates of the fire; they shall abide in it (275). Allah does not bless usury, and He causes charitable deeds to prosper, and Allah does not love any ungrateful sinner (276). Surely they who believe and do good deeds and keep up prayer and pay the poor-rate they shall have their reward from their Lord, and they shall have no fear, nor shall they grieve (277). O you who believe! Be careful of (your duty to) Allah and relinquish what remains (due) from usury, if you are believers (278). But if you do (it) not, then be apprised of war from Allah and His Messenger; and if you repent, then you shall have your capital; neither shall you make (the debtor) suffer loss, nor shall you be made to suffer loss (279). And if (the debtor) is in straightness, then let there be postponement until (he is in) ease; and that you remit (it) as alms is better for you, if you knew (280).”

Chapter 3, verses 130-134:

“O you who believe! do not devour usury, making it double and redouble, and be careful of (your duty to) Allah, that you may be successful (130). And guard yourselves against the fire which has been prepared for the unbelievers (131). And obey Allah and the Messenger, that you may be shown mercy (132). And hasten to forgiveness from your Lord; and a Garden, the extensiveness of which is (as) the heavens and the earth, it is prepared for those who guard (against evil) (133). Those who spend (benevolently) in ease as well as in straightness, and those who restrain (their) anger and pardon men; and Allah loves the doers of good (to others) (134).”

Chapter 30, verse 39:

“And whatever you lay out as usury, so that it may increase in the property of men, it shall not increase with Allah; and whatever you give in charity, desiring Allah's pleasure-- it is these (persons) that shall get manifold.”



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