AN ANALYSIS OF THE APPLICATION OF THE RULES AGAINST *RIBA* IN ISLAMIC BANKING AND FINANCE

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1.1 Introduction

The emergence of Islamic banking and finance in the Muslim world has remained the most inspiring and outstanding financial and economic phenomenon of the 21st century. Basically, Islamic banking and finance refers to banking and financial activities that are based on the principles of Islamic Law which fundamentally prohibits the charging of interest.[3] It is a finance activity that is consistent with the principles of Islamic Law which provides guidance that include coverage of a Muslim's economic activity, such as dealing in property as well as creation and distribution of wealth. The Islamic Law explains in detail ethical concepts applicable in the use of money and capital, the relationship between risk and profit, and the social responsibilities of financial institutions.[4]

The basic tenets and principles of Islamic banking and finance are built upon the avoidance of *Riba*, *Gharar* (Uncertainty) and the prohibition of impermissible businesses as stated in the Holy Quran and the *Sunnah*. Banking models are built upon the foundation of compliance with the principles of the Islamic Law. *Riba* is generally the same concept of interest or usury in Judeo-Christianity and is therefore unlawful and forbidden in Islamic Law. Instead of *Riba*, the concept of profit and loss sharing is practiced; essentially the concept

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[4] John, D. and Munib, H. (2014) *Islamic Finance & Markets: United Kingdom*, Law Business Research Ltd., London – United Kingdom, pp. 37-41; *Islamic Finance*, Australian Trade Commission (Austrade) (2010) p. 5

of risk sharing, as opposed to risk transferring permeate the system.[5] In that, of fundamental importance in Islamic commercial law (*muamalat*) is the prohibition of *riba* (usury) and the application of this principle has far-reaching effects on the transactional dynamics in Islamic Banking and Finance within the parameters of Islamic Law.[6]

Thus, the outlawing of *riba* encompasses not only the concept of usury but also that of interest and the universal nature of this principle is immediately apparent even at a cursory glance of non-Muslim literature. Usury was prohibited in both the Old and New Testaments of the Bible, while Shakespeare and many other writers, particularly those writing in the 19th Century, have attacked the barbarity of the practice.[7] Much of the morality championed by Victorian writers such as Dickens - ranging from the equitable distribution of wealth through to man's fundamental right to work - is clearly present in modern Islamic society.[8] This is because usury causes hatred and enmity between people, eradicates Allah's blessings and warrants His punishment, just as Allah said: "*Allah will destroy Riba (usury) and will give increase for Sadaqat (deeds of charity, alms, etc.)*[9] Furthermore, it must be observed that because of *Riba*, debts keep on accumulating and multiplying, leading the indebted individuals and nations to suffer from rising unemployment and recessions. In such conditions, those who have capital prefer to lend their money in return for high interest returns, instead of investing in beneficial projects, such as building factories, construction projects, and so forth.[10]*Riba* harms and works against healthy economies and public interest, often causing severe economic disasters, as all those who have a sound mind would concur.[11]

This paper aims at an analysis of the application of the rules against *riba* in islamic banking and finance. In an Islamic system, banks-in accordance with

[5]Oracle, (2017) *Islamic Banking Processes and Products Key Regional Variations*, Oracle White Paper, September 2017, p. 5

[6]Alache Fisho-Oridedi (n.d.) *The Prohibition of Riba under Islamic Law: What are the Implications for International Contracts?*, University of Dundee, p. 1; Sharawy, H., *Understanding the Islamic Prohibition of Interest: A Guide to Aid Economic Cooperation between The Islamic and Western Worlds*, 29 Ga. J. Int'l & Comp. L. 153 2000-2001

[7] Warde, I. (2000) *Islamic Finance in the Global Economy*, Edinburgh University Press, pp. 63-68;

[8] Brown, C. L.(2000) *Religion and State: The Muslim Approach to Politics* Columbia University Press, p. 196

[9] Qur'an 2:276

[10]Ibn Baaz, A. A. (n.d.) *Warning Against Riba (Usury) Transactions*, Madinah Publishers and Distributors, p. 11

[11]Khan, M. (1987) *Islamic Interest-Free Banking: A Theoretical Analysis*, in Khan, M. and Mirakhor, A. (eds.)(1987) Theoretical Studies in Islamic Banking and Finance, IRIS Books, Houston, Texas, US, p. 37

Allah's command-have to prohibit interest and speculation and engage directly in trade and investment operations. Its unbacked expansion of credit is preempted, and banks cannot initiate and accentuate a speculative process. Consequently, it is the objective of this paper to provide a viable alternative to the existing banking system imbued with interest and full speculation. Also, to appraise the extent of its application to the existing banking and finance institutions in Nigeria.

1.2 Overview of the Concept of Islamic Banking and Finance

Generally, Islamic Law is conceived as one of the most comprehensive legal systems in the world as it covers all aspects of human life, be it personal, civil, criminal, mercantile, evidence, constitutional and international law. Its rules and principles which are divine in nature are meant to provide a code of conduct whereby people are directed to lead their life in this world for the attainment of the hereafter.[12]

Islamic banking refers to a system of banking or banking activity that is consistent with the principles of the Islamic Law and its practical application through the development of Islamic economics.[13] An Islamic bank is a financial institution which identifies itself with the spirit of the Islamic Law, as laid down by the Holy Qur'an and the *Sunnah*, as regards its objectives, principles, practices and operations. An Islamic bank does not normally lend money except interest-free loans which are termed as *Qard Hasanah* (Benevolent Loans) while loans on service charge, not exceeding the actual administrative cost of such loans, have also been permitted by Muslim Scholars.[14] The Islamic Law prohibits the payment or acceptance of interest or charges (*riba*) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles.[15]

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[12]Yamani, A. Z. (1388 A.H.) *Islamic Law and Contemporary Issues,* The Saudi Publishing House, Jedda, Saudi Arabia, p. 9; Bambale, Y. Y. (2007) *An Outline of Islamic Jurisprudence*, Malthouse Press Limited, Lagos-Nigeria, pp. 9-10; See also Coulson, N. J. (1969) *Conflicts and Tensions in Islamic Jurisprudence*, The University of Chicago Press, Chicago, p. 3

[13] Khan, M. (1987) "Islamic Interest-Free Banking: A Theoretical Analysis" in Khan and Mirakhor (eds.), 1987, Theoretical Studies in Islamic Banking and Finance, IRIS Books, Houston, Texas, U.S., p. 23; Hassan, K. and Lewis, M. K. (2007) Handbook of Islamic Banking, Edward Elgar Publishing Limited, pp. 13-15.

[14]Iqbal, Z. and A. Mirakhor, (2007) An Introduction to Islamic Finance, John Wiley, Singapore., pp. 38-39; Archer, S. and Abdel Karim, R. A. (2007) Islamic Finance: The Regulatory Challenge, John Wiley & Sons (Asia) Pte Ltd., pp. 52-57; Siddiqui, S. H. (nd) *Islamic Banking: True Modes of Financing,* an online article available at: http://www.islamic-banking.com/iarticle_2.aspx (accessed on 12/8/18)

[15] Institute of Islamic Banking and Insurance [IIBI], *What is Islamic Banking?* available online at http://www.islamic-banking.com/what_is_ibanking.aspx (accessed 14/08/2018)

In order to be Islamic, the banking system has to avoid interest. Consequently, much of the literature on the theory of Islamic banking has grown out of a concern as to how the monetary and banking system would function, if interest were abolished by law. Another principle of the Islamic banking system is that there should be no reward without risk-bearing. This principle is applicable to both labour and capital. As no payment is allowed to labour unless it is applied to work, so no reward for capital should be allowed unless it is exposed to business risks.[16]

In the Holy Qur'an and the Sunnah, Islamic finance has always been conceived as the finance activity of an Islamic economy where social equity is enhanced through mandatory *Zakat*. In the Holy Qur'an, the verses that deal with interest (*riba*) have always been preceded or followed by verses that prescribe *Zakat*. Hence, when social equity is secured through *Zakat*, motives on the side of lenders to practice interest and dire needs of the poor to accept interest will disappear. In such an economy, Islamic finance will thus be essentially guided toward investment and wealth creation and much less toward consumption. The basic tenets of Islamic finance can be clearly identified in the following two verses of the Holy Qur'an where Allah (SWT) said:

> Those who devour usury will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say: "Trade is like usury, but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat the offense are companions of the Fire: they will abide therein (forever).[17] Allah will deprive usury of all blessing, but will give increase for deeds of charity; for He loveth not creatures ungrateful and wicked.[18]

From these two verses of the Holy Qur'an, two fundamental principles arise, the first is that an Islamic financial system is driven by trade and production and not by interest, since interest is forbidden; the second is that an Islamic financial system based on trade will be immune to instability, and that a system based on

[16] Khan, M. (1987) *Islamic Interest-Free Banking: A Theoretical Analysis*, op cit., pp. 25-27
[17] Quran 2:275
[18] Quran 2:276

interest is inherently unstable and prone to repeated crisis and losses.[19] Mirakhor (1988) defined an Islamic financial system as one in which there are no risk-free assets and where all financial arrangements are based on risk and profit and loss sharing.[20] Hence, all financial assets are contingent claims and there are no debt instruments with fixed or floating interest rates.

However, while modeling the financial system as non-speculative equity shares, it showed that the rate of return to financial assets is primarily determined by the return to real sector, and therefore in a growing economy, Islamic banks will always experience net positive returns.[21] This indicates that the fundamental characteristic of Islamic economics is that economic and financial activities are linked to real economic sector activities and there is encouragement to equity based structures backed by tangible assets instead of debt based ones in investment where in the conventional world the transactions may not necessarily have to be backed by any real asset.[22]

Moreover, the real alternate to interest on loans in an Islamic framework is financing on profit and loss sharing [PLS] basis- a shift from debt-based transaction to investment-based funding. It is believed that the financing on PLS system of Islamic banking in a conducive environment would not only ensure a healthier financing portfolio and of course higher rates of return to depositors but would also lead to optimum allocation of resources for over-all economic growth and welfare of the society, individually and collectively.[23]

In the Islamic banking system, the concept is that of ratios in which profits and losses are shared instead of fixed, pre-determined interest and mark-up/profit rates. The issue of possible injustice due to inflation and recession, in money lending transactions, was settled by Islamic Law over 1400 years ago, as Profit and Lost Sharing system absorbs the impact of inflation as regards the sharing of operational results are concerned. A glaring example is that of partnership where there is no dispute between partners due to high inflation or other-wise.[24]

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[19] Iqbal, Z. (nd) *Islamic Financial System*, World Bank Publication, p.45

[20] Mirakhor, A. (1988) *Equilibrium in a Non-Interest Open Economy*, International Monetary Fund, Working Paper, WP/88/111

[21] Ibid

[22] Iqbal, Z. and A. Mirakhor, (2007) An Introduction to Islamic Finance, John Wiley, Singapore., pp. 38-39; Archer, S. and Abdel Karim, R. A. (2007) Islamic Finance: The Regulatory Challenge, John Wiley & Sons (Asia) Pte Ltd., pp. 52-57

[23] Noureddine, K. and Abbas, M. (2009) "Resilience and Stability of the Islamic Financial System – An Overview", A Paper presented at the seminar held on 30 January 2009 on 'Comparative Development of the Islamic Economic Model in the Context of Current Market Conditions', Organized by KPMG, London, UK, p. 5

[24] Siddiqui, S. H. (nd) *Islamic Banking: True Modes of Financing*, an online article available at: http://www.islamic-banking.com/iarticle_2.aspx (accessed on 12/8/18)

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of the Islamic Law, particularly known as *Fiqh al-Muamalat* (Islamic rules on transactions). A popular belief persists that Islamic banking is simply an interest-free financial structure. But in fact, Islamic economics is a complete system of social and economic justice. It deals with property rights, the incentive system, the allocation of resources, economic freedom and decision-making and the proper role of government.[25] Western bankers have said that savings and investments would soon dry up if interest were not paid. But this is due to identifying "rate of interest" and "rate of return". The Qur'an says: "*God has permitted trade, but forbidden riba (interest)*".[26] Therefore, it is only the fixed or predetermined return on savings or transactions that is forbidden, not an uncertain rate of return, such as the making of profit.[27]

Islamic banking is no longer a novel experiment, even the financial circles the world over treated it as a utopian dream. Besides their range of equity, trade-financing and lending operations, Islamic banks also offer a full spectrum of fee-paid retail services that do not involve interest payments, including checking accounts, spot foreign exchange transactions, fund transfers, letters of credit, travellers' checks, safe-deposit boxes, securities safekeeping investment management and advice, and other normal services of modern banking.[28] In essence, Islamic banking has, because of its value-orientated ethos enables it to draw finances from both Muslims and non-Muslims alike. In that, Islamic banking is an instrument for the development of an Islamic economic order and some of the salient features of this order may be summed up as follows that:

1. While permitting the individual the right to seek economic well-being, Islamic Law makes a clear distinction between what is *halal* (lawful) and what is *haram* (unlawful) in pursuit of such economic activity. In broad terms, Islamic Law forbids all forms of economic activities which are morally or socially injurious to humanity.

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[25] Haque, NadeemUl and Mirakhor, A. (1999) *The Design of Instruments for Government Finance in an Islamic Economy*, Islamic Economic Studies, Vol. 6, No. 2, pp. 27-43; Iqbal, Z. and Mirakhor, A. (2007) *An Introduction to Islamic Finance*, John Wiley, Singapore, pp. 7-9.

[26] Qur'an 2:275

[27] Khan, M. (1987) "*Islamic Interest-Free Banking: A Theoretical Analysis*" in Khan and Mirakhor (eds.), 1987, *Theoretical Studies in Islamic Banking and Finance*, op cit., pp. 25-27

[28] Archer, S. and Abdel Karim, R. A., (2007) *Islamic Finance: The Regulatory Challenge*, John Wiley & Sons (Asia) Pte Ltd., p. 17; Choudhry, NurunNabi and Abbas Mirakhor, (1997) Indirect Instruments of Monetary Control in an Islamic Financial System, Islamic Economic Studies, Vol. 4, No. 2, pp. 27-65.

2. While acknowledging the individual's right to ownership of wealth legitimately, Islamic Law makes it obligatory on the individual to spend his wealth judiciously and not to hoard it, keep it idle or to squander it.
3. While allowing an individual to retain any surplus wealth, Islamic Law seeks to reduce the margin of the surplus for the well-being of the community as a whole, in particular the destitute and deprived sections of society by participation in the process of *Zakat* (a tax on wealth that is distributed to the needy).
4. While making allowance for the ways of human nature and yet not yielding to the consequences of its worst propensities, Islamic Law by its laws of inheritance seeks to prevent the accumulation of wealth in a few hands to the detriment of society as a whole.[29]

Moreover, by its nature, an Islamic banking system may have two types of banking activities, a 100 percent reserve system for safekeeping and an investment banking system. It involves safekeeping and payments activity as in pre-Islam and early Islamic period and also as in goldsmith houses. This type of activity is similar to 100 percent reserve system, with deposits remaining highly liquid and checking services fully available. This system has to be a fee-based system to cover the cost of safekeeping and transfers and payments services.[30]

The second activity is an investment activity whereby deposits are considered as longer-term savings and banks engage directly in risk taking in trade, leasing, and productive investment in agriculture, industry, and services. Most important characteristic of this activity is that it is immune to un-backed expansion of credit. An Islamic bank is assumed to match deposits maturities with investment maturities. Short-term deposits may finance short-term trade operations, with the bank purchasing merchandise or raw materials and selling to other companies; liquidity is replenished as proceeds from sales operations are generated. For longer-term investment, longer-term deposits are used. Liquidity is replenished as amortization funds become available.[31] In all these investments, an Islamic

[29]Onafowokan, O. (2003) *Non-Interest (Islamic) Banking: Principles and Practice,* Kings & Queen Associates, Lagos-Nigeria, pp. 5-79; Hanif, M. (2011) *Differences and Similarities in Islamic and Conventional Banking,* International Journal of Business and Social Science, Vol. 2 No. 2; February 2011;Olga, K. and Sylwia, N. (2012) *What's in It for Me? A Primer on Differences between Islamic and Conventional Finance in Malaysia,* International Monetary Fund
[30]Siddiqui, S. H. (nd) *Islamic Banking: True Modes of Financing,* an online article available at: http://www.islamic-banking.com/iarticle_2.aspx (accessed on 12/8/18)
[31]Choudhry, N. N. and Mirakhor, A. (1997) *Indirect Instruments of Monetary Control in an Islamic Financial System*, Islamic Economic Studies, Vol. 4, no. 2, pp. 27-65.

bank is a direct owner of the investment process which is awarded through a due diligence process. In such a system, a financial institution therefore participates directly in the evaluation, management and monitoring of the investment process.

1.3 The Concept of Interest (*Riba*) in Islamic Law

The Arabic word "*Riba*" means "increase" in or "addition" to anything. *Riba* best translated today as the charging of any interest, means money earned on the lending out of money itself. It means predetermined return on the use of money.Under Islamic Law, there are two kinds of *Riba* namely: a) *Riba al-Nasia* (postponed with using) and b) *Riba al-Fadl* (the surplus).[32] The word "*Nasia*" means delay granted to the debtor. It is used in this sense because the creditor permits the delay in payment of the debt in consideration of something in excess over the principal. *Riba al-Nasia* is a loan agreement, whereby the borrower should pay a certain extra amount over and above the payment of principal amount against the specified deferment. This is strictly prohibited as it is considered unjustified enrichment and monetary advantage without a counter value. *Riba al-Fadl* relates to the excess charged in sale transaction. It applies when commodity exchange contracts provide payment of any extra quantity of the commodities. *Riba-al Fadl* is prohibited by the Prophet (P.B.U.H.) as a precautionary and preventive measure lest it should lead to *Riba al-Nasia*. The Holy Quran has not left any ambiguity in respect to the concept and definition of *Riba*. It explicitly and categorically lays down that: "O believers, fear God, and give up the *riba* that remains outstanding if you are believers".[33] It also says: "Allah has permitted trade but forbidden *Riba*."[34] Therefore, the legal position is that if a loan is given or taken for moral or humanitarian reasons, the principal amount should be protected and any excess on that is forbidden as immoral and exploitative. If loan or investment is made for economic reasons, then the owner of the capital has no right to demand a fixed rate of return. This is because one cannot ask for any additional payment without sharing the risk of business. The Quran makes no distinction between loan given for consumption purpose or productive ventures.[35]

[32]Usmani, M. T. (1999) *An Introduction to Islamic Finance*, Idaratual Maarif, Karachi, Pakistan p. 77; Sadique, C. M. (1995) *Encyclopedia of Islamic Banking*, p. 199; *Islamization of Insurance - A Religio Legal Experiment in Malaysia*, Religion and Law Review, Vol-2, No-1, 1999, p. 22
[33]Quran 2:278
[34]Quran 2:275
[35]Ahmed, K. (1995) *Elimination of Riba: Concept and Problems - Elimination of Riba Form the Economy*, Institute of Policy Studies, Islamabad, Pakistan, p.34

It is well known facts that clear texts in the Holy Quran and the Sunnah states that both Riba al-Fadhl and Riba an-Nasia are not permissible for Muslims. And Muslim scholars stated that prohibiting Riba al-Fadhl also involves prohibiting the methods and means that lead to it. In that, when some of the Companions bartered two *Sa'i* (some measures) of inferior dates for one *Sa'i* (around 3 kilograms) of good dates (i.e., Riba al-Fadhl), the Prophet (SAW) said: "*This is Riba itself! This is Riba itself! Do not do this.*"[36]Furthermore, it was reported in the two Sahihs [al-Bukhari and Muslim] that, Abu Sa'eed Al-Khudri said that, the Prophet (SAW) said:

> Do not sell gold for gold unless equivalent in weight, and do not sell lessamount for greater amount or vice versa; and do not sell silver for silverunless equivalent in weight, and do not sell less amount for greateramount or vice versa; and do not sell gold or silver that is not present atthe moment of exchange for gold or silver that is present.[37]

Also, in Sahih Muslim, it was narrated that 'Ubadahibn As-Samit said that the Prophet (SAW) said:

> Gold for gold, silver for silver, wheat grain for wheat grain, barley forbarley, dates for dates, salt for salt: equal in weight, equal in amount andfrom hand to hand (the payment is not delayed). When these types are not the same kind, then sell as you like as long as it was from hand to hand.[38]

There are many other authentic Hadiths on this subject in the two Sahihs [Sahih Al-Bukhari and Sahih Muslims], as well as other books of Hadith.As for the Hadith that states, "*Riba involves the Nasi'ah*", the scholars stated that it only indicates the fact that most *Riba* transactions are of a *Nasi'ah* type, not all of them. The previous two Hadiths, as well as several other authentic Hadiths clearly demonstrate that there are several other types of Riba. In fact, Riba transactions usually combine both Riba al-Fadhl and Riba An-Nasia. Consequently, those who indulge in Riba with the banks, and the owners of these banks, combine two types of Riba, Riba an-Nasi'ah (delayed payment that incurs interest) and the interest itself that is collected (an addition that makes the

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[36] Bukhari, M. I. (1422) *Ṣaḥiḥ Bukhari.* Dar Ṭawq AlNajat, Berut. Hadith No. 2170
[37] Bukhari, M. I. *Ibid*, Hadith No. 2177
[38] Siddiqui, M N. (1987) *Insurance in an Islamic Economy*, The Islamic Foundation, UK, p.41

transaction of Rib al-Fadhl type), thus, carrying the burden of both illegal transactions.[39]

1.4 Prohibition of Interest (*Riba*) in Islamic Law

The charging of interest or dealing with usury while conducting commercial transactions is prohibition in Islamic Law in all forms and intent. This prohibition is strict, absolute and unambiguous. The Holy Qur'an in verses 278-279 of Surah Al-Baqarah states:

> O ye who believe! fear Allah and give up what remains of your demand for riba, if ye are indeed believers. If you do it not, take notice of war from Allah and His Messenger. But if ye turn back, ye shall have your capital sums. Deal not unjustly and you shall not be dealt with unjustly.[40]

Thus, *Riba* (usury) is considered *Haram* (impermissible) because various verses of the Holy Quran and authentic Hadiths of the Prophet (SAW) rendered it "*Haram*". It therefore, follows that interest is prohibited as it leads to injustice (*zulm*) and Islamic Law is against all forms of injustices and exploitations and pleads an economic system, which aims at securing extensive socio-economic justice. The charging of interest can leads to injustice and exploitation in society and the Holy Qur'an characterizes it as unfair, as implied by the word *zulm* (oppression, exploitation) which is the opposite of *adl* (i.e. justice).[41]

The Islamic principle concerning the prohibition of *riba* (interest) was originally not based on economic theory but on Divine Authority which considers the charging of interest as an act of injustice. These prohibition on paying or receiving fixed interest is based on the Islamic tenet that money is only a medium of exchange, a way of defining the value of a thing; it has no value in itself, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else. The human effort, initiative, and risk involved in a productive venture are more important than the money used to finance it. In that, money in Islamic Law is not regarded as an asset from which it is ethically permissible to earn a direct return. Money tends to be viewed purely as a medium of exchange.

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[39] Ibn Baaz, A. A. (n.d.) *Warning Against Riba (Usury) Transactions*, Madinah Publishers and Distributors, p. 16

[40] Qur'an in verses 278-279, translation from Abdullah, Y. A. (1987) *English Translation of the Meanings of the Holy Quran*, Presidency of Islamic Researches, IFTA, Call and Guidance, King Fahd Holy Quran Printing Complex, Jeddah

[41] Siddiqui, S. H. (nd) *Islamic Banking: True Modes of Financing*, an online article available at: http://www.islamic-banking.com/iarticle_2.aspx (accessed on 12/8/18)

There is no real 'lending' in Islam since all 'lenders' obtain ownership interests in the assets that they finance, or earn a profit-share or purely fee-based remuneration. In order for an Islamic bank to earn a return on money lent, it is necessary to obtain an equity, or ownership, interest in a non-monetary asset. This requires the lender to also participate in the sharing of risk.[42]
People may be well accustomed with the burden of interest and misery and suffering that irresponsible lenders have inflicted on individuals and societies. It has become so completely institutionalized and accepted in modern economies that it is almost impossible to conceive that there would be some people who would completely oppose it and refuse to enter into any transactions that involve interest.

1.4 The Legal Danger of Interest (*Riba*) in Islamic Law

Islamic Law prohibits *Riba* because it is often ruinous to the borrower and at the sometime makes the lender greedy and selfish. Islamic Law seeks to protect the weak from exploitation. The prohibition of *Riba* is accepted by all the Muslim jurists. It is an absolute prohibition which covers simple and compound interest, productive as well as nonproductive loans. Even in case of productive loans guaranteed return on capital is unjust and prohibitive. Both the Holy Quran and the Sunnah prohibit *Riba* and those who disregard the prohibition of *Riba* are in direct conflict with the injunction of Allah (SWT) and that of the Prophet (PBUH).[43]
Thus, *Riba* is completely prohibited under Islamic Law; because the Islamic Law does not consider money as commodity as such that there should be a price for its use. Islamic Law does not permit gain from financial activity unless the beneficiary is also subject to risk of potential loss; and that Islamic Law regards the accumulation of wealth through interest as selfish compared with that accumulated through hard work. It makes no difference whether return is fixed or variable percentage of the principal, an absolute amount to be paid in advance or maturity, or a gift or service to be received as a condition of the loan.[44]

As per the requirements of Islamic Law, interest free loans are meant for cooperative and charitable activities. So far as commercial financing is

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[42] Usmani, M. T. (1999) *An Introduction to Islamic Finance*, IdaratualMaarif, Karachi, Pakistan, p. 19
[43] Usmani, Ibid, p.23
[44]Mortuza Ali, K. M.(nd) *Fundamental Islamic Law and Financing Principles as Applicable to Takaful (Islamic Insurance)*, p. 6, an online publication available at: https://islamicmarkets.com/publications/fundamental-islamic-law-financing-principles-as-applicable-to-takaful(accessed on the 23/8/18)

concerned, the Islamic Law has a different set up for the purpose. The principle is that the person extending money to another person must decide whether he wishes to help the opposite party or he wants to share in his profits. If he wants to help the borrower, he must rescind from any claim to any additional amount. The principal amount will be secured and guaranteed, but no return over and above the principal amount is legitimate. But if he is advancing money to share the profits earned by the other party, he can claim a stipulated proportion of profit actually earned by him, and must share his loss also, if he suffers a loss. This means, if financing is meant for a commercial purpose, it can be based on the concept of profit and loss sharing.[45]

What is forbidden in the *Islamic Law* is the fixed and predetermined return against commercial financing. Variable return on the basis of actual productivity and profitability of a venture is perfectly legitimate. As such, all modes of financing under Islamic Law have to be risk sharing and consequently profit-and-loss sharing. One of the most important characteristics of Islamic financing is that it is an asset backed financing. Islam does not recognize money as a subject matter of trade, except in some special cases. Money has no intrinsic utility; therefore, there is no room for making profit through the exchange of these units *interse*. The profit earned through dealing in money is interest, hence, prohibited. Financing in Islamic Law is based on non-liquid assets which create real assets and inventories.[46] Islamic Law does not recognize capital and entrepreneur as two separate factors of production. Every person who contributes capital to a commercial enterprise assumes the risk of loss, therefore, is entitled to a proportionate share in the actual profit. In this manner, capital has an intrinsic element of entrepreneurship, so far as the risk of the business is concerned. Instead of a fixed return as interest, it derives profit.[47]

It is noteworthy that exclusion of interest from financial activities does not mean that the financier cannot earn a profit. If financing is meant for a commercial purpose, it can be based on the concept of profit and loss sharing. [48] Therefore, "*Mudarabah*" (profit and loss sharing) and "*Musharakah*" (limited partnership) are the well-known forms of profit-and-loss sharing in Islamic finance. These

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[45]Mortuza Ali, K. M.(nd) *Fundamental Islamic Law and Financing Principles as Applicable to Takaful (Islamic Insurance),* an online publication available at: https://islamicmarkets.com/publications/fundamental-islamic-law-financing-principles-as-applicable-to-takaful(accessed on the 23/8/18)

[46]Usmani, M. T. (1999) *An Introduction to Islamic Finance*, IdaratualMaarif, Karachi, Pakistan, p. 19

[47] Ibid, p. 22

[48]Siddiqui, M N. (1987) *Insurance in an Islamic Economy*, The Islamic Foundation, UK, p.41; Obaidullah, M. (2000) *Regulation of Stock Market in an Islamic Economy*, Paper presented at the 4th International Conference on Islamic Economics and Banking, held at Southborough University, U.K., August 2000.

two forms of Islamic financing have been designed since the very inception of the Islamic Commercial Law (*Muamalaat*). The contemporary scholars have also suggested other forms of Islamic financing. In the past, there has been dispute about whether *Riba* refers to interest or usury. But, there is now consensus amongst Muslim scholars that the term *Riba* covers all forms of interest and notonly excessive interest.[49]

Moreover, the cardinal principle is that all transactions, commercial or non-commercial, individual or corporate, private or public, which involve a predetermined rate of return on loan, in money or in kind fall within the scope of *riba* and as such are forbidden. Advances, loans, and interest-based financial instruments used by banking and financial institutions are not permissible under Islamic framework. Therefore, Muslims have evolved several alternate instruments of financing. Islamic Law allows loan giving and loan taking under certain circumstances on ethical and philanthropic grounds. The concept of debt-based economy is alien to Islamic approach. Under an Islamic aegis, self-financing, cooperative financing, indirect financing have a role to play on the basis of risk sharing and not on the basis of a predetermined fixed return. Financial capital can earn income only by bearing and sharing risk of losses. Therefore, to be Islamic, all banks, insurance companies and financial institutions will seek and provide finances which will always have some element of risk bearing.[50]

Furthermore, according to Islamic principles, a financier must determine whether he is advancing a loan to assist the debtor on humanitarian grounds or he desires to share his profits. If he wants to assist the debtor, he should resist from claiming any excess on the principal of his loan. However, if he wants to have a share in the profits of his debtor, it is necessary that he should also share with him in his losses. This is called under Islamic terminology the principle of "*Musharakah*", which literally means sharing. Since Islamic Law has prohibited any form of interest, "*Musharakah*" can play a vital role in the Islamic financial system.[51]

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[49] Mortuza Ali, K. M.(nd) *Fundamental Islamic Law and Financing Principles as Applicable to Takaful (Islamic Insurance),* P. 7; an online publication available at: https://islamicmarkets.com/publications/fundamental-islamic-law-financing-principles-as-applicable-to-takaful(accessed on the 23/8/18)

[50] Mortuza Ali, K. M.(nd) *Fundamental Islamic Law and Financing Principles as Applicable to Takaful (Islamic Insurance),* p. 8,an online publication available at: https://islamicmarkets.com/publications/fundamental-islamic-law-financing-principles-as-applicable-to-takaful(accessed on the 23/8/18)

[51] Warde, I. (2000) *Islamic Finance in the Global Economy,* Edinburgh University Press, p. 63

As for the ethical as well as economic justification for the prohibition of *riba*, it is three-pronged: *riba* is unfair, it is exploitative, and it is unproductive.Under a traditional interest-based relation between borrower and lender,the borrower alone either incurs the losses or reaps disproportionatelyhigh benefits. Conversely, the lender makes money irrespective of theoutcome of the business venture. Islam prefers that the risk of loss be shared equitably between the two. In other words, rather than collecting a'fixed, predetermined' compensation in the form of interest, lendersshould be entitled to a share from any profits from a venture they havehelped to finance. The broader argument is that any profit should bemorally and economically justified. Hence, the injunctions against lavatory contracts and *gharar* (Uncertainty) where gain is the result of chance or undetermined causes. As in other religions, *riba* was also seen as exploitative, since it tended to favour the rich, who were guaranteed a return, at the expense ofthe vulnerable who assumed all the risk.[52]

Thus, it is ardent to note that, one of the pillars of the Islamic economic and financial system is the very prohibition of *Riba*. This prohibition cannot be isolated nor can it be used as ammunition against the Islamic faith. The Islamic prohibition of *Riba* is only one of the many blessings it has brought to mankind. The prohibition of *Riba* by Islamic Law has brought about the eradication of one of the root causes of human conflict. Indeed, this is in consonance with the Islamic general objective of building a healthy society in which peace, harmony, cooperation and collaboration are its cornerstones.[53]Absolute prohibition of *Riba* or interest in the Quran and the *Sunnah* is a command to establish an economic system in which all forms of exploitation are eliminated. The prohibition of interest is a way to establish justice between the financier and entrepreneur.

Likewise, *Riba* (usury) causes hatred and enmity between people, eradicates Allah's blessings and warrants His punishment, just as Allah said: "*Allah will destroy Riba (usury) and will give increase for Sadaqat (deeds of charity, alms, etc.)*[54] Furthermore, it must be observed that because of *Riba*, debts keep on accumulating and multiplying, leading the indebted individuals and nations to suffer from rising unemployment and recessions. In such conditions, those who have capital prefer to lend their money in return for high interest returns, instead

[52]Warde, Ibid, p. 63

[53]Kharfa, A. F. (2000) *Interest and Usury in Islamic & Positive Law*, Paper presented in International Conference on Takaful, Khalalumpur-Malaysia, June 2000, p. 13; Mortuza Ali, K. M.(nd) *Fundamental Islamic Law and Financing Principles as Applicable to Takaful (Islamic Insurance)*, an online publication available at: https://islamicmarkets.com/publications/fundamental-islamic-law-financing-principles-as-applicable-to-takaful(accessed on the 23/8/18)

[54] Qur'an 2:276

of investing in beneficial projects, such as building factories, construction projects, and so forth.[55] *Riba* harms and works against healthy economies and public interest, often causing severe economic disasters, as all those who have a sound mind would concur.

1.5 Conclusion

This paper has examined the concept of interest (*riba*) within the Islamic banking and finance framework and it has highlighted the implications of the prohibition of interest-based transactions in the Islamic banking industry. Accordingly, the following are the findings of this paper:

1. Firstly, it is has been observed that the prohibition of interest (*riba*) is the pivotal platform to base the implementation of Islamic banking and finance. Thus, in contrast to conventional banking system, Islamic banking and finance emphasize on profit-and-loss sharing rather than interest-based financial practices and policies.

2. Secondly, it is also the finding of this paper that avoidance of *riba*-based transactions is the key to the successful implementation of Islamic banking and finance and that both private and public financial institutions and deposit money banks in Nigeria should embrace interest-free banking to enable a segment of the populace that subscribe to this creed for patronage.

On the basis of the above, the following recommendations are hereby made:

1. It is recommended that the Islamic banking system should not work side by side with *riba* banking as seen today; instead, it should operate as a sole and single system in a sole and single Islamic financial system operating in a *riba* free economy. For this purpose, the application of interest in commercial transactions in the Islamic banking sector should by law be rendered illegal and such transactions should be made statutorily unlawful and void on the basis of the prohibition of *riba*.
2. It is recommended that investors, financier's, depositors, and all other stockholders in Islamic states must of necessity have a grasp of the concept and transactions within the Islamic Banking and Finance industry that are structured to conform to the dictates of Islamic Law as applicable in the different jurisdictions as regards the prohibition of *riba* and ensure sharia-

[55] IbnBaaz, A. A. (n.d.) *Warning Against Riba (Usury) Transactions*, Madinah Publishers and Distributors, p. 11

compliance of all products and services rendered by full-fledged and subsidiary Islamic banks and windows respectively.