‘Why Islam has prohibited Interest & Islamic Alternatives for Financing’

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‘So lose not heart,
Nor fall in despair,
For you are bound to rise,
If you are true in faith’

Al-Quran 3:139

‘The collapse of the global marketplace would be a traumatic event with unimaginable consequences. Yet I find this easier to imagine than the continuation of the present regime’

George Soros,

INTRODUCTION

Most prohibitions in Islam are easy to understand. The effects of alcohol are abundantly clear with approximately 65% of all weekend violent incidents being fuelled by alcohol. Similarly, the ills of gambling are clear, and with the new casino legislation being proposed in the U.K, may Allah protect our community. However when it comes to Interest, few Muslims can fully comprehend the evils of this vice, and thus the prohibition on Interest does not appear to resonate with us as seriously as it should. Part of the problem which leads to this apparent fallacy is that unlike alcohol and gambling the evils of interest are difficult to comprehend on an individual level. As Muslims we generally also struggle to appreciate the significance of interest, and by extension the resulting economic system on a society wide macro scale.

However, in so far as the non Muslim countries are concerned, interest and the corresponding economic systems have played a massive role which is clear to see. The ‘cold war’ dominated global politics for most of the twentieth century and was all about pitting Capitalism against Communism. These two competing economic systems perceived money and interest in different ways and led to numerous wars and the ‘iron curtain’ across Europe.

Crucially Islam is not silent on the role of interest, and on the resulting matters of economic growth and fair distribution of wealth amongst society. Given the recent collapse of Communism and the perception of many in the West of Islam being the new ‘threat’ Islamic economics is being studied closely the world over. Only by placing the evil of interest within a society wide context can we begin to appreciate some of the wisdom behind the unparalleled curse of a ‘declaration of war’ from Allah (SWT) & his Messenger (SAW) which is directed towards those refusing to give up Interest.

Insha’allah it is our Intention through this booklet to first study the definition & chronology of the prohibition of Interest in the Qur’an. We will then move on to analyse the effects of Interest on the Global economy. Finally we will introduce the Islamic Alternative to Interest financing, known as ‘Musharaka’, and exhibit a working model of this alternative. First though, let start at the beginning by defining Interest.

INTEREST DEFINED

The standard dictionary definition of Interest is as follows

'a charge made for a loan or credit facility'.

Seems innocent enough. At first glance it seems reasonable for a charge to be levied in exchange for receiving a loan. The reality though is that Islam's position on capital receiving a return is somewhat different to the western standpoint. Whilst the concept of investment is understood relatively similarly by both ideologies, the nature of return on loan-capital differs massively. The capitalist system believes in capital's unbridled right to a return without any real risk being undertaken. This is by definition Interest. Whilst Islam fundamentally disagrees with the above view; and instead proposes that if capital is lent on a 'loan' basis then it must be repaid with no excess; any excess in Interest. If the lender seeks any return on his capital, then he must invest his funds and partake in the losses, risks and rewards of business. Even to the neutral observer, the Islamic position presents superior logic. Why should idle capital receive a return for no work undertaken, especially when most idle capital, as we will see, was artificially created in the first place.

So let us now revise our definition of Interest. Indeed, what better way to define the term than from the Holy Qur'an. In Surah Baqarah, Allah dedicates a number of verses to Interest; from them we can infer the following definition for Interest;

'Any excess paid or received on the principal'

The prohibition on Interest is bilateral. Neither can the borrower pay it, nor can the lender receive it. So whilst investing money is halaal and can generate a positive return, a loan cannot and must be repaid at par with no excess.

THE CHRONOLOGY & HISTORICAL CONTEXT OF THE QURANIC BAN ON INTEREST

As with many other prohibitions detailed on the Qur'an eg alcohol, the prohibition on Interest was revealed in stages. No doubt this gradual change was best suited to the mentality of a people, which like most of the world today, could not see the problems with Interest and hence a one-stop ban may have been difficult to digest. The gradual ban on Interest can roughly be summarised into 3 stages.

Stage 1 – Clarifying that Riba carries no reward with Allah.

Stage 2 – Outright Ban on Interest but not retrospectively.

Stage 3 – Reiterating the Ban on Interest and imposing a retrospective Ban.

The interpretation of revelations is rarely easy, and as such should only be undertaken by a qualified Alim. Hence, at this juncture, it would be prudent to analyse the historical context within which the above verses were revealed and their interpretation by the Ulema.

Stage 1 – Clarifying that Riba (usury) carries no reward with Allah

The first ever verse revealed on Riba was Surah Ar-Rum, verse 39, where Allah says;

'And whatever Riba you give so that it may increase in the wealth of the people, it does not increase with Allah'

This was a Makkan Surah. Numerous Ulema have felt that 'Riba' in this verse does not refer to Interest per se, but rather makes reference to 'a gift'. However, other commentators such as Hasan Al-Basri have reportedly taken this verse clearly to mean usury. In either case the most that can be inferred from this ayah is that Riba carries no reward from Allah. It is not possible to infer any ban imposed.

The next occasion when Interest is explicitly mentioned is in Surah Nisa, verse 4. Allah says

'And because of their charging Riba, whilst they were prohibited from it'.

The exact historical date of this verse is difficult to determine but scholars are certain that it was prior to 4AH. This is because the verse is commenting upon the outlawed practices of the Jews, who were forbidden in the Torah from engaging in Usury, yet still persisted. Of the 3 Jewish tribes in Medinah, namely Banu Nadir, Banu Quraiza & Banu Quainiqa, all had been banished from Medinah by 4AH, hence the verse relating to their business practices must have been revealed prior to their extrication. However the exact date of this revelation is still not fully certain.

Stage 2 - Outright Ban on Interest but not retrospectively on existing loans

The Next occasion on which Interest is mentioned in the Qur'an is somewhat easier to date on the timeline, as it relates to a key historical event, namely The Battle of Uhud. The verse is in Surah Al-Imran, verse 130 where Allah says

'O those who believe do not consume up Riba, doubled & redoubled'.

In his landmark work, the historic Judgment on Interest, Justice Taqi Usmani observes the following about the above verse. 'This verse of Surah Al-Imran which is estimated to have been revealed some time in the second year after Hijra, this is because the context of the preceding and succeeding verses refer to the Battle of Uhud which took place in 2 AH. This verse clearly contains a clear prohibition for the Muslims, and it can safely be said that this is the first verse of the Holy Qur'an in which the practice of Riba was expressly prohibited for Muslims'.

Some commentators have felt that the reasoning behind this revelation was to discourage Muslims from financing their armoury for the Battle of Uhud via usurious loans. The Kuffar had amassed substantial armoury via usurious loans, and hence the verse prevented the Muslims from following them. There are also other events such as the conversion and subsequent Shahadah of Amr ibn Aqyash which support the above reasoning.

Stage 3 – Reiterating the Ban on Interest and imposing a retrospective Ban on RIBA outstanding on all loans.

The final stage in the revelations, sealed the casket on Riba.

Shortly after the conquest of Makkah in 8AH the most extensive and damning indictment of Interest was delivered in the Qur'an in Surah Baqarah, where Allah says

'Those who take usury will not stand on the Day of Judgment except as he who has been driven mad by the touch of the Demon. "That is because they have said trading is like Riba", but Allah has permitted trading but prohibited Riba. Whosoever receives an advice from his Lord & stops, he is allowed what has passed, and his matter is up to Allah. And the ones who revert back are the people of the Hellfire. There they remain forever……………………….Oh you who believe give up what remains of Riba if you are believers. But if you do not then listen to the declaration of War from Allah & his messenger (SAW). If you repent, your is your principal and nothing more………………………..'

This is the longest revelation on Riba in the Qur'an and it reinforces a few key messages. Firstly the definition of Riba is afforded no obscurity, Allah clearly defines Interest as 'any sum received above the capital'. Secondly, the Qur'an sealed the fate of those persisting in Riba, by stating their abode as the hellfire. Thirdly, such is the despicable nature of Riba that Allah notifies the believers of a 'declaration of war' if they do not desist.

The historical context of this verse surrounds the tribe of Banu Thaqif, who laid their retention of interest owed to them down as a pre-condition of their entrance to Islam. When the Prophet (SAW) received the treaty, he simply added a sentence which stated that Banu Thaqif would have the same rights as the Muslims. Banu Thaqif though however perceived that their treaty had been accepted by Prophet Mohammed (SAW). Consequently a matter arose between Banu Thaqif & Banu Amr Ibn Al-Mughirah, whereby Banu Thaqif refused to pay Interest on outstanding loans, yet still wished to receive it from debtors.

At this juncture the above verse was revealed, which clearly banned Interest. Consequently, Banu Thaqif relinquished their claims stating that they had no power to fight Allah & his messenger.

The historic statement proclaimed by Rasulullah (SAW) at the time of the last sermon clearly outlawed all outstanding Riba. The Prophet SAW, during the sermon, in 10 AH, he proclaimed,

‘All Interest obligation shall henceforth be waived. Your capital however is yours to keep. You neither wrong, nor be wronged. Allah has judged that there be no Riba and that all Interest due to Abbas ibn Abd Al-Muttalib shall henceforth be waived’

Now that we know the historical context and the key features of the verses on Riba, it is worthwhile looking briefly at some of the arguments proposed by supporters of Riba to justify it within an Islamic context. This exercise will also be useful as a means of dispelling some common myths on Interest eg that the Qur’an intended only to outlaw ‘excessive interest’.

COMMON MISUNDERTSANDINGS ABOUT RIBA

The misunderstandings are best summarised into 5 distinct arguments. These arguments were all presented to the Shariat Court of Pakistan during the hearings which sought to overturn the ban on Interest, that had been introduced. The arguments and their explanations are as follows.

MISUNDERSTANDING 1 – The verses of the Qur'an which prohibit Riba were revealed in the final days of the life of the Prophet (SAW) and as such he did not have much time to interpret them. Therefore, they should fall in to the category of Mutashabihaat (ambiguous/unclear) verses. This being the case, an absolute ban cannot be imposed based upon Mutashabihaat grounding.

RESPONSE – The reality is that the ban on Interest was actually revealed in 2 AH, around the time of the Battle of Uhud. The verse in Surah Al-Imran (quoted above) is the verse in question. With regards to the verses in Surah Baqarah, they reiterate the ban on interest and enforce a retrospective ban on all previous loans and any interest due at that time. As the verse in Surah Al-Imran was revealed in 2 AH, sufficient time existed in between than and the Prophet's (SAW) death to fully explain the implications of it.

MISUNDERSTANDING 2 – Riba refers only to usurious loans on which 'excessive interest' is charged. Modern Banking loans do not fall into this category.

RESPONSE – This misconceived argument relates to text in Surah Al-Imran which states 'do not consume riba, doubled and redoubled'. However, this does not mean that the definition of Riba is when double the principal is repaid. Rather, the Qur'an was just commenting upon some of the prevailing practices of the time where such extortionate rates of Interest were applied. In fact, the definition of Interest was made explicitly clear in Surah Baqarah, where Allah states that 'If you repent, yours is your principal, and nothing more'. This clears the misconception.

MISUNDERSTANDING 3 – The Qur'an only bans Riba on consumption loans (ie those loans forwarded to the poor for basic subsistence). When it comes to commercial loans, as in vogue today, no such ban has been imposed

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RESPONSE – The ban in the Qur'an is an absolute ban on Interest. The Qur'an makes no distinction between consumption and productive loans. Neither does the Sunnah of Mohammed (SAW) make any such distinction. Proponents of this line of argumentation, have argued that loans given in Arabia at the time of this revelation, were to the poor for consumption of daily needs and hence exploitative rates of interest tantamount to exploiting the weak. They then argue that as commercial loans were not in existence, they are not covered by the Ban. The reality though is that historians have proved the existence of much commercial activity in Arabia at the time. Arabia was barren land, and hence the Makkans unable to farm or cultivate, were forced to try their hand at business and trade. Dr Jawad Ali, whose famous research and work on Arabs in Jahiliyya, supports the assertion of Arabs being veteran traders. This then being the case, commercial loans would not have been alien to the Arabs.

MISUNDERSTADING 4 – Only Riba al-Jahiliyya was banned by the Qur'an, and not Interest present in today's commercial transactions. Riba al-Jahiliyya relates to a practice whereby a loan was advanced for a certain period with no interest charged. However if at the end of the period, the capital had not been repaid then the loan would be rolled over for another period and interest charged. As commercial loans today specify interest rates right from the outset, they do not fall within the ambit of Riba al-Jahiliyya.

RESPONSE – This line of logic is flawed in many ways. Islam has banned any repayment above principal (Surah Baqarah), hence whether that repayment is immediate or after a certain timeframe, is irrelevant. It is still Riba and therefore Haraam.

MISUNDERSTANDING 5 – Though Riba is overtly haraam, the doctrine of necessity in Islam permits certain activities to be engaged in due to necessity. For example, the eating of pork and drinking of wine if no other means of survival exist.

RESPONSE – Whilst the doctrine of necessity is recognised in Islam, and as such appropriate concessions can be made. However, the real question is whether or not the status quo is so bad that the 'doctrine of necessity' should apply. Supporters of this line of argument often overlook the fact Islam has its own financial principles with which an economy functions. They are largely based around profit and loss sharing between investors. Numerous world-class economists have analysed the Islamic theories of asset-backed economics and gold/silver as currency. Economists such as Chapra, Mirakhor etc. Even the former British Governor of the Bank of England, Eddie George has frequently attended conferences extolling the virtues of Islamic finance. The sad reality is that Muslims all over the world are so obsessed and influenced by western ideas and notions that any other rival system of progression is cynically viewed as regressive. The west seems to rule supreme, and in the material comforts it offers, Muslims have become deluded and will follow in the West's footsteps at any cost. Thus the notion of deeming an 'Interest' based economy as a must under the doctrine of necessity is to do with a vain attempt to emulate the west rather than any genuine necessity.

Many International business figures working in the sphere of Islamic Finance have also commented favourably on the viability of Islamic finance, even in isolation in a world where no other country may be implementing it. Such figures include Dr Ahmed Mohammed Ali, President of the Islamic Development Bank, Jeddah and Iqbal Khan, CEO, HSBC Amanah Finance.

THE WISDON BEHIND THE BAN ON INTEREST

Whenever Allah (SWT) reveals a law unto humanity, it quite often exhibits mercy for humanity. Indeed the Prophet (SAW) has been described as a mercy of the whole of mankind. Now mankind is at times trapped into a ‘cause and effect’ understanding of the world eg walking into the middle of the road when traffic is in full flow may be injurious and even fatal, hence one waits till the traffic has cleared before crossing.

Whilst this mindset has advantages, it is limited to the level of intellect possessed by man. Indeed if a situation presents itself which is harmful to man, but as yet he does not possess the requisite knowledge to know, (except for a cautious few) he will probably proceed with that action. An example of this could be smoking prior to the direct link to cancer being proved. Hence, as man is limited in his intellect, and Allah has no limitations, then wisdom behind certain divine laws will resonate easily with man, whilst the wisdom behind others may be somewhat more difficult to grasp, and indeed due to man’s limitations wisdom behind some may never be grasped. The above is referred to in fiqh as ‘Illat at & Hickma’ ie the basic feature of an action and the wisdom governing the law on it.

Allah has not explicitly stated the wisdom behind the ban on Interest, and as such mankind can only speculate as to the real reasons behind this ban. However, one point must be made clear – the ban is absolute and covers all possibilities (unless the doctrine of necessity genuinely applies), and is not contingent upon mankind’s understanding of the wisdom behind it. Naturally then as Muslims we unreservedly accept the divine prohibition on interest. After that though, we can speculate on the reasoning behind this ban.

Many international economists and financial experts for decades and centuries have documented the ills of Interest. Though the subject of the externality posed by Interest to an economy and on society in general is a subject worthy of a book in its own right, we will present a few key succinct arguments and facts which should convince any neutral reader on the problems caused by Interest. We will start with a brief history lesson on the roots of today’s banking system, following which we will present a model which shows how the rich always get richer and the poor poorer. Finally we shall look at the shocking situation which debt has been responsible for in the 3rd World.

A BRIEF HISTORY OF INTEREST BASED BANKING

'The modern Banking system manufactures money out of nothing. The process is perhaps the most outstanding piece of sleight of hand that was ever invented…If you want to be slaves of the Bankers, and pay the costs of your own slavery, then let the Banks create money'

Lord Josiah Stamp, Former Director, Bank of England

The origins of banking go back to the Goldsmiths of the 16th Century who used to store Gold for the general public and in return issue receipts. Hence when the receipt was presented to the Goldsmith, he would give back the Gold coin(s). The Goldsmiths used to store the Gold coins on shelves in their storerooms which were known as Banks. Hence, the term 'bankers'. As time went on the general public started exchanging the receipts themselves as a means of offsetting their debts against each other. The system relied heavily on the integrity of the Goldsmiths and their ability to pay up when presented with the receipts.

At this critical juncture, the Goldsmith's discovered one of the greatest albeit unethical money making ideas of all time. The Goldsmith's realised that people were not returning to them regularly for the Gold coins and that the receipts they had issued were being exchanged as legal tender. As long as the public's confidence was retained in these receipts then they could be printed and issued without any corresponding Gold being deposited. The market could then be flooded with these artificial receipts, which would be used as legal tender. This would allow huge loans to be forwarded to the general public, thereby entitling the Goldsmith to Interest on the loans. As time went on, the Goldsmiths realised that they needed to hold less and less Gold in relation to receipts issued. Hence, the birth of the **Fractional reserve system**.

Fractional reserve was an extraordinary system which allowed a huge expansion in the money supply via money creation. This new money was then used to forward loans and indebt the general public.

Of course, there was one big ethical question posed at this juncture – is it correct for a banker to issue paper receipts, without the corresponding Gold in reserves, Hence, prompting a potential situation whereby depositors come to reclaim their funds and cannot do so as they no longer exist ? This very question was at the centre of a huge Banking debate in the 1800's. Many bankers felt that such an attitude was pure dishonesty and nothing more, thus it should be avoided. Other Bankers though could not resist the temptation of this new money making scam and hence lobbied for a fractional reserve ratio. Ultimately, the Bankers agreed upon 20% as the reserve which had to be kept in store, in relation to receipts issued.

Now the question will be asked, surely a system based on dishonesty will be exposed sooner or later. Artificial currency based largely upon consumer confidence must be exposed sooner or later. To witness the exposure of this dishonest system and indeed how it can bring economies to the brink of collapse, we will fast forward our timeline a few decades to the 19th Century.

RECENT NOTABLE FINANCIAL CRISES CAUSED BY FRACTIONAL RESERVE

The debt economy fuelled by fractional reserve expanded and engulfed into debt almost all who came in contact with it. Until 1931, the Bank of England was willing to exchange £1 for certain ounces of Gold. However, with money creation via the fractional reserve so heavily out of control, that the Bank of England rescinded its promise and was no longer willing to make this exchange. In the US, the situation was worse, as the Federal reserve called in all Gold deposits from the general public. It then became an offence to own Gold. Only institutions were afforded this privilege. These drastic steps had to be taken because the general public was rapidly losing confidence in paper currency, and its ability to be converted to gold on demand by the banks, and even the central bank.

It was at this point that the historic Bretton Woods agreement in 1944 was signed. This agreement destroyed the link between a country's currency and gold, for all countries except America. The deal was that all the World's currencies would be pegged against the dollar which in return would be backed by Gold. Hence, the integrity of a domestic currency would be based upon its conversion to dollars which in turn the Federal Reserve would undertake to exchange for Gold. This system worked well for a few years, but unfortunately the ghosts of fractional reserve soon caught up, as the Federal Reserve was itself allowed by the Federal Reserve Act to operate a reserve ratio, and hence issued notes way in excess of Gold held in reserves.

In 1971, the entire monetary system came close to collapse due to fractional reserve ratios. In response, President Nixon abolished the link between the Dollar and Gold. This spelt doomsday for the general public. Now there was no means of backing paper currency to real gold. History bears witness to various occasions when the domestic public no longer had confidence in their own currency and thus demanded payment in either gold or dollar. Most recently, this situation transpired in Argentina, when the Banks had insufficient dollars to pay out the equivalent of the domestic currency. The Argentine Government then outlawed the withdrawal from Banks of dollar receipts. On that occasion, public confidence in the dollar existed and as such, domestic currency could still loosely be valued. With money creation by Global Banks, reaching unprecedented levels, and the severance of any link between the dollar and real currency eg 'Gold', what will happens when confidence in the 'almighty' dollar collapses. Where will the world turn to redeem the value of worthless paper receipts ?

Of course, numerous international figures have understood the mischievous nature of debt and its chief wielder, western Banks. In a paper by Tarek El-Diwany titled 'debt, the real terrorist', Mr Diwany reminds us of the statements of grave concern expressed by U.S presidents and British chancellors on the International Money Masters of debt. The quotes are as follows;

Thomas Jefferson

If the American people ever allow the ***banks*** *to control the issuance of their currency, first by inflation then by deflation, the banks and corporations that will grow up around them will deprive the people of all property until their children will wake up homeless on the continent their fathers occupied. The issuing power of money should be taken from the banks and restored to Congress and the people to whom it belongs. I sincerely believe that banking institutions are more dangerous than standing armies.*
Thomas Jefferson, the Writings of Jefferson, vol. 7, "Autobiography, Correspondence, Reports, Messages, Addresses and other Writings", Committee of Congress: Washington D.C., 1861, page 685

Abraham Lincoln
"The government should create, issue and circulate all the currency and credit needed to satisfy the spending power of the government and the buying power of the consumers. The privilege of creating and issuing money is not only the supreme prerogative of government, but it is the government's greatest creative opportunity. By the adoption of these principles ... money will cease to be the master and become the servant of humanity. Democracy will rise superior to the money power"
Abraham Lincoln, Senate Document 23, USA, 1865

Frank Knight
"In the abstract it is absurd and monstrous for society to pay the commercial banking system interest for multiplying several fold the quantity of the medium of exchange when a) a public agency could do it all at negligible cost, b) there is no sense in having it done at all, since the effect is merely to raise the price level, and c) important evils result, notably the frightful instability of the whole economic system."
Frank Knight, p. 732, Saturday Review of Literature, UK, 1927

Well suffice to say, the stranglehold Banks can bring to bear on an economy has been well understood even by the 'powers that be. However even they appear powerless in the face of ruthless domineering Banks. The journalist Bill Still once produced a video/DVD titled 'The Money Masters'. It is an awesome exposure of the roots, deception and control of the International Banks.

INFLATION OF GOODS OR DEFLATION OF MONEY?

At this juncture, I would like to sight an example of the dangers of money creation, which affect all of us citizens of this country. The example is sighted by John Tomlinson in his book, Honest Money. I have anglicised the example for the purposes of this booklet. Imagine in 1980 you have £5,000 in your bank account. You contemplate whether you should spend this sum on a lavish new 3 series BMW (costing £5000) or whether you should do the sensible thing and save the money for a rainy day. You remember the advice of your Grandfather and decide to save the money as deposits in a high interest Bank account. In 1990, you return to the Bank to withdraw your capital. You find that not only do you receive your £5,000 capital but also some additional Interest of £1,000. You are impressed. You then return to the car showroom in anticipation of rewarding yourself and finally now buying the 3 series BMW. However, to your utter amazement, the same BMW now costs £10,000. You are £4,000 short. What happened ? You followed your grandfather's advice and saved the money, yet you seem to have lost out.

Now economists would offer you scant solace in the form 'inflation'.. Many economists would say that prices in general increase and so more money is needed to buy the same commodity. This explanation though is untrue and hides one of paper money's greatest deceptive qualities. As more artificial money is pumped into an economy, each unit of money reduces in value, as the underlying asset base of the economy stays the same. This then means that goods (eg BMW) have to increase in price to receive the same relative level of currency for their exchange value. Thus the reality is that currency is depreciated every time the Bankers inject more artificial amounts in. Hence the only way, sellers can compensate themselves for this decrease in purchasing power is by increasing prices. Hence the deflation of money is the real culprit, and indeed the root cause in the inflation of price.

In recognition of this deception, modern economics has devoted an entire school of thought to 'Monetarism' which advocates controlling inflation through restricting the money supply. Whilst these economists have correctly identified a key problem, sadly they have failed to diagnose the correct solution which is to link money entirely with a corresponding real asset and do away entirely with the fractional reserve concept.

RICH JUST GET RICHER

'Modern-day capitalism has mastered the art of stealing a man's rights, and then selling them back to him as a privilege'

Now that we have an appreciation for the history of banking and we also know that most money in any economy is dishonestly created artificially by bankers rather than the state, we can now study how this mass of artificially created money is used to enslave humanity via debt, and to ensure the rich just keep getting richer.

Remember the old adage, 'Bankers only lend money to those who do not need it'. Seems contradictory at first sight, but under the superficial cover is a glaring reality. When Banks forward money in the form of loans they tend to favour giving loans to those with the greatest collateral. Why, because collateral is the only security the Bank has in the event of the borrower defaulting. Now since the wealthiest people have the greatest collateral, they are able to borrow the greatest amounts.

This tendency of the banks directly inhibits and reduces economic growth for the entire society. Clearly, the most profitable projects are rarely those which offer the banks the most collateral. In fact the opposite is true. Therefore, if money was to flow to those projects with the best potential for profit, and not those with the most collateral, much more profit would be generated overall, which would benefit everyone in society.

This slowing of the economic growth rate is massively exacerbated by another consequence of using interest as the basis on which to borrow money. The money inevitably is loaned to those who least need it, the very wealthy. This in turn leads to the very wealthy making the greatest profits as they have taken the majority of the capital. Therefore the rich just get richer whilst the poor rarely get a chance to obtain the capital needed to improve their lot.

To illustrate the point, consider the following 2 statistics;

'The richest 225 people own more wealth than the poorest 2.5 Billion'

United nations Development report, 1998

'In 1998, 64.5% of all bank loans in Pakistan were forwarded to under 0.5% of the Population'

Historic Judgment on Interest

The first statistic clearly exhibits how internationally the wealth is massively skewed in favour of an elite group of wealth-holders. The second statistic demonstrates the natural outcome to such a skewed system. That, the overwhelming majority of loans in a country are forwarded to the most extreme wealthy minority.

Another way of illustrating this point would be to observe the working mechanics of a bank and its relationship between the depositors and borrowers.

The bank receives its funds from ordinary depositors like you and me. It then needs to make a profit on such funds and thus lends them out to those who have sufficient collateral to serve as security against loans. As this tends to be the wealthiest, they plough their money into various business ventures. When profits accrue from the venture, a small percentage are given to the Bank as an Interest payment for the money lent. The bank takes its cut of these profits, and then passes on a meagre amount to the depositors as Interest on current/Deposit accounts. Islam sees 3 key problems with this approach;

1) The Capitalist puts up at best 10% of the capital in a business venture. The Bank via depositors provides the remaining 90% of the capital. Why then does the capitalist keep almost all the profits, short of interest payments.
2) The Bank receives a return in the form of Interest regardless of the fortunes of the borrower, this is unfair, as the Bank should also take some risk in the venture, if it wishes to profit,
3) The depositors who provide most of the capital, receive a meagre, insignificant part of the return. Surely they should receive more.

Any neutral observer can see the problems the above system causes on a macro basis to any economy. Islamic finance operates a system called Musharaka which ensures that the above inequities do not occur. We will examine Musharaka in part X of his booklet.

THE CATASTROPHIC IMPACT OF DEBT INTEREST ON THE DEVELOPING WORLD

They no longer use bullets and ropes, they use the World Bank and IMF

Jesse Jackson

We must find new lands from which we can easily obtain raw materials and at the same time exploit the cheap slave labour that is available from the natives of the colonies. The colonies would also provide a dumping ground for the for the surplus goods produced in our factories'

Cecil Rhodes, Founder of Rhodesia

'The new nomadic Capital never sets down roots, never builds communities. It leaves behind toxic wastes, embittered workers and indigenous communities driven out of existence'

Anita Roddick, Founder of 'The Body Shop'

The highly depressing mess caused by Debt and Interest in the 3rd world is today evident for all to see. Countries spend up to 40 – 50% of their GDP funding Debt interest payment to Private Western Banks, or the IMF/World Bank syndicate. Quite often debt payments contribute a larger proportion of GDP than that spent on Education, Healthcare and infrastructure combined. The enslaving of the developed world by no means ended with the withdrawal of colonial powers, rather debt has shackled down the futures of generations in these countries. But how did it ever get this bad ? Well, let's start again at the Bretton Woods agreement where 2 global institutions were born with noble aims, at least on the face of it.

The institutions in question were the World Bank & the IMF (International Monetary Fund). In 1944, the IMF & World Bank were developed. The objective of the World Bank being to provide developmental assistance for non-commercial projects and the IMF was to assist nations in short-term balance of payments difficulties and to ensure stability.

In 1987, the Institute for African Alternatives (IAA) called for the dissolving of the IMF & The World Bank, largely on the grounds that they had done more harm than good to the developing world.

What happened in the years between 1944 & 1987 has been the subject of scores of critical academic study. Here are a few key statistics which have been developed on the back of extraordinary empirical research.

- In 1989, The World Bank conducted a review of its policies and was unable to point to one single project which had improved the lives of the citizens in the country in question.
- No country has ever paid off debt taken from the World Bank or private Banks
- The Debt imposed by the World Bank is not on the heads of individual leaders, but rather the responsibility of the people in the sovereign state. This way round there is no escaping the reckless action of a bad dictator.
- For many developing countries, debt Interest often constitutes a greater % of GDP than Education, Healthcare and infrastructure combined
- Debtor countries started off 1990's 61% deeper in debt than 1980's
- During 1982-90, developing countries paid £1.3Bn in Interest & Capital to creditor countries
- Largest faith group in 3rd World are Muslims

I have quoted in the sources section, at the end of this booklet, the works of various excellent authors such as Michael Rowbotham, Susan George and many more, all brilliant economists who have presented great insight into the 3rd World debt problem.

In a nutshell though, the problem is that when loans are forwarded to the developing world, they are not linked to any specific developmental projects, and as such are pure interest-bearing debt. Naturally then, a string of corrupt leaders have benefited from this system. Michael Rowbotham, humorously referrers to them as the *aidocracy* in his classic work, the Grip of Death. The lending institutions, guilty themselves of not being investment partners with developing countries, and rather pre-occupied with generating a return on idle capital, continue to cast millions and billions of dollars into a black hole which will realistically never by sewn up, and as such plunges the people of the sovereign state into perpetual debt-slavery.

Had the lenders kept the welfare of citizens of the of the borrowing country at heart, then they would either have been much more calculated in the amounts they lent, making future lending contingent on positive results from previous lending. Or better still, the lending institutions would become partners in the enterprise for which funds are being lent and as such would be extra-vigilant in ensuring corruption does not have its way and that society benefits whilst simultaneously creating a profit for the investors. Sadly, how often in life is the net result of an activity pre-determined by the intentions of the key parties involved. The debt-ruined state of the developing world bears witness to this philosophy.

The situation is now so bad in the 3rd World that as the above statistic shows, the repayment of debt Interest now constitutes a greater percentage of GDP for most countries than key expenditure such as healthcare and education.

Of course, the most depressing statistic of all is that the largest faith group in the 3rd world are Muslims.

Now that we have a gained a thorough understanding of the nature of debt-finance and the international catastrophes it is responsible for, we can move on to understand the Islamic solution to progressing an economy, without using debt. As mentioned before, this solution is called musharaka. However, just before we delve into Musharaka, it will be valuable to understand Islam's views on money and its role within the economy. As you will see, Islam's views on this subject matter differ fundamentally to the western viewpoint, and as such may well possess the answer to solving our international debt crisis before it is too late.

THE NATURE OF MONEY IN ISLAM

The biggest downfall of the interest-based system is that it treats money as a commodity which can be profited from in its own right. Islam fundamentally disagrees with this presumption and treats money purely as a medium of exchange which in its own right cannot generate a profit. In the west, just as a businessman can sell any commodity eg a property at a profit above its cost, so too money is sold at a profit above its face price eg trading of Bonds. In a similar manner, the west has no problem with lending capital and claiming a return as interest. Islam does not accept the above treatment of money and critically differs from the west in the following 3 fashions.

1) In Islam, money has no intrinsic utility. It cannot be directly utilised to fulfil and human needs or desires. It can only be used for acquiring some goods and services which in turn satisfy human needs. A commodity on the other hand does have intrinsic utility eg a house can be resided in or a car to be driven in. As such, money having no intrinsic utility cannot be traded, whilst commodities possessing intrinsic utility can be traded in.
2) Commodities can be of varying qualities whilst money has no inherent quality eg a dirty £10 note is as good as a crisp, clean £10 note. Whilst an old car is definitely not worth the same as a new car, even if it is the same model and make. The minute a car is driven off the showroom, it usually depreciates by a few thousand pounds.
3) With commodities, sale and purchase is effected by specifying a certain commodity. For example, at an auction you would select a specific car to bid for. Whilst with money, there is no 'specific' identity. If I purchase a car for £5,000 of you. I can either pay for it with the £5,000 in my personal possession, or indeed the £5,000 in my bank account. There is no difference.

Due to the above key differences, Islam has laid down 2 key rules for Muslims to live by when it comes to the exchange on money per se.

1) Money is to act a medium of exchange and a measure of value and as such can never be traded in as a commodity in its own right. The trading of monetary debts as is prevalent on capital markets today is referred to as *Bai Ad-Dain* in Arabic and is expressly prohibited by the Prophet (SAW).
2) Secondly, barring a few exceptional circumstances, money has to be exchanged for money if it is borrowed. The payment on each side must be equal, so as to ensure that money itself does not become the subject of trade.

Historically economists categorised all goods as either as productive goods (ie it generates productivity eg land) or consumption goods (eg food consumed). Unfortunately, they did not account for commodities such as money which would not fall into either of the 2 categories. Hence, with this twofold definition; as money certainly could not be eaten, it had to be classified as a productive good.

In his classic work ‘The theory of money & credit’, Ludwig von Mises criticises the classic economic approach, by stating the following;

‘It is true that the majority of economists reckon money amongst production goods. Nevertheless arguments from this authority are invalid. The proof of a theory is in its reasoning, not its sponsorship; and with all due respect to the masters, they have not justified their position very thoroughly on this matter’

During the great U.K depression of the 1930’s an economic crisis committee war formed by Southampton University. The committee discussed the root causes of the depression and amongst its recommendations was the following;

‘In order to ensure that money performs its true function of operating as a means of exchange and distribution, it is desirable that it should cease to be traded as a commodity’.

Is this not what Islam said over 14 centuries ago. We are only today coming to the realisation of a system which Allah had ordained since time immemorial. In fact in his groundbreaking work ‘Ihya Al-Uloom Ul-Deen’, Imam Ghazzali says the following about money;

‘The creation of Dirhams and dinars are a blessing from Allah (SWT) as they have no intrinsic usufruct or utility, but everybody needs them as every human being needs commodities for eating, wearing etc. Often man does not have what he needs, or has what he does not need……therefore transactions of exchange are inevitable. But there must be a basis of measure on which price can be determined as the exchanged commodities are neither of the same type nor the same size…….Therefore all these commodities need a mediator to judge their exact value, hence Allah (SWT) has created dirhams and dinars’

‘……………..so whoever uses money contrary to its basic purpose is in fact disregarding the blessings of Allah. Whoever hoards money is doing injustice to it……..and whoever effects transactions of interest on money is in fact discarding the blessing of Allah (SWT) and is committing injustice; because money was created for other things, not for itself’

Now that we have fundamentally established the difference between money, purely as a medium of exchange in Islam, we can proceed to analyse musharaka which is Islam’s answer to trading productively without debt.

MUSHARAKA – ISLAMIC FINANCING

‘Musharaka’ is derived from the Arabic root verb ‘shirkah’ which means to ‘jointly participate’. It denotes the concept of a joint venture between 2 parties when entering into business. Musharaka lies at the heart of Islamic Financing philosophy, where the notion of sharing in risk and return between investors and entrepreneurs finds its natural home. Musharaka is quite similar to a conventional ‘partnership’ arrangement as understood in the West.

The basic rules behind musharaka are that any wealth-holder wishing to receive a return on his capital, must engage in risk to generate that return. Musharaka affords him this opportunity. He is able to invest capital in a business venture with another like-minded investor, together they can experience the perils and pitfalls of business. At the end of the day, if a profit is generated then it is shared between these partners in a pre-agreed ratio. Any losses generated must be shared in relation to capital invested.

Musharaka can be structured on a fund basis, whereby various investors aggregate their funds together in a common pool. The manager of this pool, termed the ‘musharaka fund manager’ (MFM), will be responsible for selecting the best possible projects to invest his clients’ funds in. Naturally the MFM will select only those projects which represent the best possibility of profit. The manger may also take into consideration other factors such as the benefit derived by the project for the Muslim community, the permissibility of such a project under shariah, the capital intensity exhausted in the project etc.

The benefits of Musharaka are extraordinary. The concept is designed to directly link an investment to productive activity. Hence, the incentive of making money on money, and thus not contributing to economic productivity is no longer a problem. All investments in musharaka have an underlying commercial reality and as such it is directly in the interests of the investors to do their utmost to ensure the joint venture succeeds. If it does not, they will both suffer a financial loss. The musharaka approach fosters the most conducive circumstances for society’s economic prosperity.

Another great benefit of Musharaka is that it prevents an investor with insufficient capital having to resort to a Bank and borrow money on interest, which is prohibited in Islam. The investor can invite a partner or number of partners to join him in his venture and they can pool their funds together for mutual benefit. As this system avoids interest, it prevents the ‘declaration of war’ referred to earlier in the Qur’an, from Allah and his messenger (SAW). Of course, in cases where a person does not have capital but instead possesses the technical know-how of a certain business market, then Islam has a mechanism which allows capital-holders to employ their mutual capital managed by an expert, with a view to profitability. This is known as Mudaraba.

POTENTIALS CONERNS OF MUSHARAKA FINANCING

Naturally, a system such as Musharaka, which has been ordained by Allah (SWT), and which is capable of solving the World's financial problems, will not be implemented without having to fight against a number of hurdles. The most common stumbling blocks, experienced in trying to implement Musharaka, and their remedies are listed as follows.

1) **Risk of Losses –** Musharaka by definition is a risky venture. It is the direct exposure of capital to a dynamic business environment which brings with it the world of risk, and of course the possibility of corresponding return. Critics of Musharaka often argue that the overt possibility of loss experienced by capital invested will deter investors. This line of argument is flawed in a number of ways.

Firstly, investors are well accustomed to the concept of risk and reward. They fully appreciate that the only way to generate returns superior to those from high interest bank accounts or a low-risk property investment is to venture into some from of higher risk equity investment. The proof of this is for all to see with the existence of stock markets all over the world where listed companies attract investors to buy shares in them, principally on the basis of superior financial returns. Hence, if investors are willing to engage in stock-market risk all over the, world, then Musharaka in general represents exactly the same type of risk and as such should attract similar investor-types and capital. An investment in various equities as undertaken by a normal investor, either by personal portfolio planning or via a unit trust etc is in reality quite similar do a diversified musharaka portfolio, where the musharaka fund manager selects specific businesses to invest the pool's funds into. There really is not a huge difference.

Secondly, Musharaka aims to promote a society-wide attitude of investing in the economy. Whilst this may bring with it certain risks to client capital, it is still the best way of boosting the economic productivity and thereby prosperity of any nation. Such increased prosperity in the long-run will no doubt compensate the investor for any loss suffered in the short-term. How often do we witness the lowering of a central Bank's base rate in order to incentivise the general public to withdraw funds from banks and put them to productive use. These funds may either be savings or even loans forwarded by the bank. The lowering of the interest rate dually serves to make borrowing cheaper and to lessen the attraction storing idle capital in the Bank, attracting meagre interest.

Thus, even the west recognises that the stimulation of any economy is not via its hallmark product, namely Interest. Rather by citizens redirecting their capital away from Interest-based accounts and ploughing it towards productive economic use in the domestic economy.

2) **Definition of Profits –** This line of argument does carry some credibility. In the west, scores of tax consultants make a living on advising clients how to increase their expenses account, and thus reducing their profit chargeable to taxation. This is because there exists a difference between 'tax avoidance and tax evasion', the former is perfectly legitimate and encouraged whilst the latter

is illegal and can result in imprisonment. The reality is that quite often a client's accounting profits will differ to his profits for taxation purposes. And whilst a lot of the difference can be attributable to genuine reasons such as expensing depreciation of an asset over its useful life, or indeed claiming capital allowances under government incentive schemes, these can however cause some issues between the Musharaka Fund Manager (representing his client's interests) and the entrepreneur whose business has been invested in. However, assuming that the parties can agree on the exact definition of profit (even though this may differ from the strict legal definition) before engaging in business, then this definition will be used to allocate profits.

3) **Client Dishonesty on declaration of profits –** If this happens with a significant number of investments in the musharaka, then it could seriously jeopardise the capital/return of the initial investors and thereby the integrity of the entire musharaka. However, the above concern can be drastically reduced and even eliminated if a few careful steps are taken by the Musharaka Fund manager.

Firstly, the manager would ensure that the greatest possible degree of due diligence has been conducted not just on the client's business plan, but also on the integrity of the client themselves. References would have been sought on the client in addition to scrutinising his track record.

Secondly, the client may be asked to furnish a security which will compensate the musharaka fund in the event of any negligence, fraud or dishonesty on behalf on the client. Thirdly, the musharaka fund manager may also take some active part in the client's business, eg as a non-executive director on the board, involved in key decisions. This will allow the manager regular contact with the business and hence drastically reduce the possibilities of fraud.

Finally, a sophisticated accounting system with numerous checks and balances should be implemented by the client. Such a system will track the flow of funds throughout the business process thereby retaining its integrity. No doubt regular audit inspections will benefit from such intricate accounting systems.

4) Client's concerns on secrecy of his business – Some clients are concerned about a financier's day to day involvement in their business as it may jeopardise trade secrets and indirectly benefit competitors. This argument though is also quite shallow. The reality of western banking and certainly venture capital funds is that they quite often occupy a non-executive directorship on the management board. Such a directorship serves only the purpose of monitoring an investment for the venture capital firm, it does result in any adverse information dissemination activity for competitors. In addition, the Musharaka manager can be asked to sign a secrecy agreement curbing him from divulging client details to any 3rd Parties.

Now that we also fully understand the Islamic philosophy of financing, the next logical step would be to analyse its success at the global level. To sight examples of musharaka and compare them to western debt-based institutions. Sadly though, the reality is that not a single institution in the world of Islamic Finance is proactively on a significant level engaged in Musharaka financing. The very cornerstone, ethos and epitome of Islamic Finance has not been implemented anywhere. It is a highly depressing situation. It is part due to the fact that Islamic Finance is at best only 3 decades old and that all the organisations dealing in the market are still coming to terms with its true message. Quite often these institutions do not have the backing of their domestic governments and as such have a variety of legal hurdles to overcome in implementing the most basic of products.

It is also partly due to the fact that many institutions involved in Islamic Finance today are simply not bothered about progressing the true financial aspirations of Islam, and that devices such as 'murabahah' have served as the perfect vehicle via which these huge corporate Banks with their almost limitless mountains of capital have now found in murbahaha & Ijarah a halaal home via which to generate a return out of the Muslim community.

However in every dark cloud there is a silver lining, and for musharaka it is this. Our firm, 1st Ethical with the mercy of Allah (SWT) has undertaken the task of setting up the world's first musharaka financing system – insha'allah. We hope and pray that Allah (SWT) blesses the venture and makes it means of establishing true musharaka.

THE 1ST ETHICAL MUSHARAKA FUND

‘The only thing that is required for evil to succeed, is for good men to do nothing’

The following is an extract from the marketing brochure by 1st Ethical, on the musharaka fund. The extract is a summary of the intentions and activities of the fund.

‘Musharaka’ is derived from the Arabic root verb ‘shirkah’ which means to ‘jointly participate’. It denotes the concept of a joint venture between 2 parties when entering into business. Musharaka lies at the heart of Islamic Financing philosophy, where the notion of sharing in risk and return between investors and entrepreneurs finds its natural home.

Musharaka is a business venture which will attract capital from the all individuals in society and employ it in nurturing the most lucrative business ideas. This pure equilibrium will be achieved by the intelligent attraction of capital and comprehensive due diligence. The net result will be interest-free financing for the best business ideas, whilst simultaneously enabling capital to generate extraordinary investment returns.

It has long been accepted that equity investment over the long-term will always out-perform both property and debt-instruments. With the Property market reaching saturation, and the debt bubble threatening to burst at any time, the stage is perfectly set for Musharaka to prove the merits of equity-financing.

Interest based financing has never been able to equitably or efficiently allocate profit between the lender and borrower resulting in the persistent concentration of wealth in the hands of the few. When the principle incentive underpinning commercial financing changes from a guaranteed interest based return to become profit sharing then both the borrower and lender will prosper. Not just in absolute terms but also for each citizen relative to one another. Wealth distribution will be better balanced than under the current status quo. In addition, such a system would make far more efficient use of available capital thereby lifting productivity and profit for all.

It is this ideal which via Musharaka we hope to emulate. As Lincoln famously said ‘money rightfully fulfils its role as a ‘medium of exchange’ and becomes the servant of all humanity, not the master’.

You can find out more on 1st Ethical’s musharaka fund by logging on to www.firstethical.com or ringing 01204 559914. We humbly request that you remember this venture in your du’aas.

SUMMARY

‘So lose not heart,
Nor fall in despair,
For you are bound to rise,
If you are true in faith’

Al-Quran 3:139

The challenge of reforming the current financial system and reviving within it the true principles of Islamic Finance bears serious parallels with reviving the general state of the Muslim Ummah. Decadence which has set in over centuries will never be cured over just a few decades. It is always easier to slide down a slippery slope than to climb a steep mountain. Nonetheless, there lies at the heart of Islamic philosophy a concept which can make us all winners even in the decrepit situation we find ourselves in today. The teaching is simply this *‘Allah judges his servants, not on the results of their actions but on basis of their efforts exerted’*. This quite simply exhibits the beauty of Islam and the reality behind how it can raise ordinary Muslims to extraordinary levels. Islam recognises that the result to any given situation, even as big as changing the world’s economic order is only in the hands of Allah. As such, mankind cannot be judged via this yardstick. *By Allah, had the pre-requisite to venturing on this road to musharaka been a clear, concise tangible achievement within our life-spans, then we would never have set foot on this path; as the challenge is too great for limited mortals like us. But we take every step in the knowledge that Allah has already determined the success or otherwise of our venture, and that out reward is purely in trying our very best.*

This booklet has defined the concept of Interest, concluding that Interest is any amount repaid or received above the principal. We have then analysed all the Quranic revelations relating to Interest and their historical contexts. We clarified that the ban on Interest was revealed in 2AH, around the time of the Battle of Uhud; thus sufficient time existed for the Prophet (SAW) to explain the concept to the Muslims. We then also dispelled all the myths purported by wielders of Interest who have tried to legitimise the concept.

We continued to look at the wisdom behind the ban on interest concluding that though Allah has not clearly specified and particular reason, there exists mountains of evidence as to the ills of Debt and Interest. We took a brief history lesson and learnt about the deceptive practices of money creation by the 16th century goldsmiths and how these practices laid down the foundations for the modern-day fractional reserve system. We also looked at the catastrophic state which debt has plunged the developing world into. We had a critical look at institutions such as the IMF & World Bank, which after half a century, still cannot point convincingly to any project where they have benefited the borrowing country.

We then moved onto the Islamic solution to this international financial disorder. We firstly clarified Islam’s position on money being simply a ‘medium of exchange’ and not a commodity which can be traded in its own right. We then looked into the concept of Musharaka which is Islam’s answer to economic progression. A system which promotes joint participation between investors into business projects; where profits and losses are shared between these investors. A system where real capital is invested into real underlying assets into real productive projects. This unbroken link which ties capital to productivity is almost non-existent in western economies. We then looked at criticisms of Musharaka, ranging from the risk of losses to client dishonesty; and presented convincing counter-arguments to all the objections.

Finally we introduced 1st Ethical's Musharaka fund, which stands alone as the first ever in the world aimed at achieving true musharaka. May Allah bestow Barakah on the Venture. Ameen.

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