UNDERSTANDING THE ISLAMIC PROHIBITION OF INTEREST: A GUIDE TO AID ECONOMIC COOPERATION BETWEEN THE ISLAMIC AND WESTERN WORLDS

*Hesham M. Sharawy**

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* J.D. 2001, The University of Georgia.

I. INTRODUCTION

Imagine the following scenario: Mohamed, a devout Muslim, is famous for making the best falafel sandwiches in town. The recipe is a secret, handed down from generation to generation. Those who were familiar with his sandwiches urged Mohamed to open a restaurant so that others could enjoy this culinary delight. Though he always loved the idea of owning his own business, Mohamed thought it would be too difficult from a financial perspective. After much consideration, though, he decided at the very least that he would give it a try.

He worked tirelessly on developing the plans for his new business. After developing a business plan, he was ready to secure the money necessary to get his idea off the ground. Mohamed went to his local bank in Matteson, Illinois to try to secure financing for his venture. After consideration of his idea and weighing the risks involved in financing his business, the bank approved Mohamed's loan request. The terms of the agreement were typical of a loan transaction. Under the agreement, Mohamed would be obligated to repay the bank the principal amount of the loan plus a set rate of interest over a term of monthly installments.

A few years later, "Mohamed's Fantastic Falafel" won numerous awards and was named one of the Culinary Institute of America's ten-best restaurants. His success allowed Mohamed to not only satisfy his obligation to the bank, but also to fulfill his religious obligations by making significant contributions to his community, giving jobs to those who would otherwise be unemployed, and giving generously to charity.

The above scenario is a simplified illustration of the development of small business in most capitalist systems. What if, however, instead of the United States, Mohamed lived in Iran, a non-capitalist country governed by Islamic law (*Shari'ah*)?[1] The chief difference between the capitalist and Islamic systems is that the Islamic system of banking and finance is interest-free.[2] When examined from a Western perspective, the chances that Mohamed would be successful under this legal framework are quite slim. Questions arise about the effectiveness of such a system and its ability to foster the entrepreneurial

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[1] *See* ALAM E. HAMMAD, ISLAMIC BANKING THEORY AND PRACTICE 40-41 (1989) (noting that pursuant to the total Islamization of the government of Iran in 1979, the government transformed its banking system in order to effectuate the changes of the new Islamic government). It should also be noted here that the term *Shari'ah*, the Arabic term for Islamic law, will be used interchangeably with "Islamic law" throughout this discussion. *See, e.g.*, RODOLPHE J.A. DESEIFE, THE SHAR'IA: AN INTRODUCTION TO THE LAW OF ISLAM 1 (1994).

[2] *See* HAMMAD, *supra* note 1, at 1.

spirit, as well as questions regarding the ability of Islamic banks and their Western counterparts to effectively transact business during this time of unprecedented economic globalization.[3] These questions have contributed to a growing skepticism held by the West regarding the viability of systems of banking and finance based on a legal framework that forbids interest.[4]

It is clear that traditional methods of financing under capitalistic systems are wholly dependent on the concept of interest, and without it, these systems would likely not succeed.[5] Since this notion is so entrenched in the psyche of those under a capitalist regime, if at all possible, it is rare, for them to grasp the concept that an interest-free market could be successful.[6]

Given this rationale, why give any consideration to the subject of Islamic banking and finance at all? Just a few decades ago, it likely would have been a waste of time to expend any energy at all on the subject. At that time, the topic of interest-free banking was not part of a serious debate since most of the existing financial institutions of the time mainly served the limited needs of the local citizenry. After all, most regions under the *Shari'ah* were, for all intents and purposes, financially insolvent.[7] Since then, however, with the

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[3] *See* GERD G. KLÖWER, INTERNATIONALES SYMPOSIUM, ISLAMIC BANKS AND STRATEGIES FOR ECONOMIC COOPERATION 9 (1982).

[4] *See* SHAHID HASSAN SIDDIQUI, ISLAMIC BANKING: GENESIS & RATIONALE, EVALUATION & REVIEW, PROSPECTS & CHALLENGES 71 (1994).

[5] *See id.* at 37 (noting that "capitalism recognizes the unfettered right to own property and income and allows unbridled competition, monopoly, and concentration of wealth. Individual initiatives and liberties are the driving force which aim for the welfare of the society. Interest is the backbone of the system." *Id.*).

[6] *See* HAMMAD, *supra* note 1, at 19 ("The capital theory in Western economics revolve[s] around the rational use of interest rates, proving that 'zero interest rate' is impossible because no one would be willing to loan out money without a return on their money. Thus, the return-on-capital is the interest."). Returning to the hypothetical scenario of "Mohamed's Fantastic Falafel" will illustrate this point. Were it not for the initial loan from the bank, the benefits of his venture could never have been realized. The bank's decision to assume the risk of lending Mohamed the money was based on its ability to obtain a definite profit from charging interest on the amount of the loan. Interest, therefore, is pivotal to the financing of such transactions in a capitalist economy. Put simply, the charging of interest gives banks and other financial institutions the ability and the incentive to finance both the development of business and the acquisition of consumer goods, which in turn leads to a healthy and productive economy. Thus, with the view that interest is a crucial economic element, it logically follows that non-interest based systems would naturally fail.

[7] *See* RODNEY WILSON, BANKING & FINANCE IN THE ARAB MIDDLE EAST 1 (1983). Since then, the number of Muslims has increased dramatically in the world. It seems only natural to initiate a debate about tailoring a system to their particular concerns. *See* C.G. WEERAMANTRY, ISLAMIC JURISPRUDENCE AN INTERNATIONAL PERSPECTIVE, 166-67 (1988) (stating that: "[t]here are several independent Islamic states in the world—a substantial proportion of the membership

accumulation of wealth from the oil industry, the domestic economies of some Islamic countries went from insolvency to great wealth almost instantaneously. With this increase in wealth came the reality that these countries did not possess the wherewithal to effectively deal with such significant amounts of money.[8] Further, they face the difficulty of trying to effectively manage their assets while also adhering to the outright ban on interest under the *Shari'ah*.

As a result, these Islamic states were forced to follow Western modes of banking and finance mainly because their existing financial institutions were unable to deal with the vast amounts of capital.[9] Recently, however, under a growing trend of religious conservatism, many Islamic countries have realized that continuing to follow Western banking and finance methods undermines their adherence to Islamic ideals. Because of this surge in Islamization, a movement to reform the practices of financial institutions in many Islamic countries has developed.[10]

As the Islamic banking and finance movement continues toward solidifying a standard system of banking, non-Islamic countries, which were previously unconcerned with *Shari'ah* compliance, now find that their economic health may be affected by the emergence of Islamic economies.[11] Non-Islamic countries, which previously transacted business with the Islamic world on their own terms, are now facing increased pressure to restructure transactions based on *Shari'ah* compliance.[12] Further, as the number of Muslims in non-Islamic

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of the United Nations. They contain a population of over 700 millions [sic]. In addition, 300 million Muslims live in non-Muslim states, making a total of a billion, or nearly a quarter of the world's population. In 28 countries Muslims constitute more than 85 percent of the population while in 69 countries there is a significant permanent Islamic population.").

[8] *See* SHAHRUKH RAFI KHAN, PROFIT AND LOSS SHARING: AN ISLAMIC EXPERIMENT IN FINANCE AND BANKING 7 (1987) (describing one of the theories of the revival of Islamic banking as the result of the new-found wealth among the Muslim OPEC members).

[9] *See* S.H. AMIN, ISLAMIC BANKING AND FINANCE: THE EXPERIENCE OF IRAN 15 (1986) ("Until fairly recently, the entire banking system in all Muslim countries was patterned after the Western banking system . . . [which] was inconsistent with Islamic law primarily because of disapproval or [sic] *riba* . . . .").

[10] *See* Volker Nienhaus, *Islamic Economics, Finance and Banking—Theory and Practice*, *in* ISLAMIC BANKING AND FINANCE 1, 5 (Butterworths eds., 1986) (citing that Islamic banking began experimentally in Egypt in the 1960s).

[11] *See* WEERAMANTRY, *supra* note 7, at 166-67 (describing ". . . an increasing need for non-Islamic countries all over the world to negotiate with Islamic countries on a multitude of matters . . ." and that Islamic countries' "influence in world affairs is growing and their economic strength is immense. No world order of the future is possible in which the Islamic segment of the world's population—and hence Islamic ideas—do not play a major role.").

[12] It should be noted that the term "non-Islamic country," when used in regard to the transaction of business, encompasses both private individuals as well as corporations within

countries grows, financial institutions within those countries may lose a tremendous amount of capital because of their inability to meet the financial needs of their respective Muslim communities.[13] These and many other problems lead to the conclusion that for both Islamic and non-Islamic countries to reap the benefits of economic success and solve these problems, it is vital that banking communities in non-Islamic countries fully understand Islamic banking and finance.[14]

Consequently, this note will attempt to provide such an understanding through an examination of the background of Islamic law as well as of Islamic views of banking and finance. Next, the note will contrast the Islamic system with capitalist systems and introduce alternatives to interest-based banking and finance created by the Islamic banking and finance movement in an attempt to comply with the *Shari'ah.*

II. BACKGROUND

A. Sources of Islamic Law

A clear understanding of Islamic banking and finance requires at least a basic knowledge of the governing law, which in turn, depends upon a comprehension of the sources of Islamic law.[15] There are two primary sources of law in Islam: the Qur'an and the *Sunnah*. The Qur'an is the holy book of

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those countries.

[13] *See Islam in the United States FACT SHEET*, (visited January 22, 2001) <http://usinfo.state.gov/usa/islam/fact2.htm>. For example, the number of Muslims in the United States as of mid-2000 has been estimated at 4,175,000. Estimates also show that by the year 2010, the number of Muslims in the United States will rise to make Islam is the second largest religion after Christianity. *See id.*

[14] It must be emphasized here that the only way to achieve a true understanding of Islamic banking and finance is to not look at the Islamic system through "Western eyes." In other words, to fully understand Islamic banking and finance, it is necessary to understand Islam from a broadly encompassing perspective. An excerpt from DeSeife's book on the Shari'ah may help clarify this point: "Much has been written on Islamic law... [y]et often, because the perspective of most Americans is not grounded in an adequate knowledge of Islam, misconceptions abound, particularly as to the real meaning of the Shar'ia... Viewed as a system of law without the context of the religious and ethical provisions of the Qur'an, the Shar'ia may strike us as a throwback to the medieval times when witches were burned at the stake in Christian countries." DESEIFE, *supra* note 1, at 1.

[15] To simply state where the law in Islam originates does not contribute to a full understanding of the subject unless one keeps in mind the basic difference between the legal systems of Islamic and non-Islamic countries. Islamic law is based on "God-made" law whereas many non-Islamic countries are based on "man-made" law.

Islam, and it is considered to be the direct words of God as spoken to the Prophet Muhammad.[16] The *Sunnah*, on the other hand, is "a rule deduced from the sayings or actions of the Prophet either in a specific pronouncement or action or in his approval of an action or practice of someone else, as recorded in *hadith* or tradition."[17]

Where neither the Qur'an nor the *Sunnah* can address a particular situation, Islam turns to several other sources of law. Among them are the "*ijma'* (consensus) and *qiyas* (reasoning by analogy)."[18] The validity of *ijma'* law comes from the Prophet Muhammad's observance that communal decisions are free from error because they are reached unanimously (provided of course that the decision is not inconsistent with the Qur'an or the *Sunnah*).[19]

If neither the primary sources of law nor *ijma'* deals with a particular issue, the matter is then decided by jurists through *qiyas* (analogy) or by *ijtihad* (individual reasoning).[20] Although law in Islam is determined only by the word of God as spoken through the Prophet, justification for the development of law in Islam via analogy or individual reasoning is attributed to a specific *hadith*.[21]

It should be evident that the *Shari'ah* is based on a hierarchy of principles, and legal questions in Islam are answered using a "top-down" approach. In other words, the first place of consultation when an issue arises is the Qur'an,

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[16] *See* FUAD AL-OMAR & MOHAMMED ABDEL-HAQ, ISLAMIC BANKING THEORY, PRACTICE, & CHALLENGES xvi (1996).

[17] *Id.* at 1 (stating that although *hadith* is a term that is often used instead of *Sunnah*, *Sunnah* actually refers to a tradition of the Prophet while *hadith* refers to the rule that is deduced from this tradition).

[18] *Id.*

[19] *See id.*

[20] *See id.*

[21] *See id.* (describing the Prophet's approval of the decision of a case based on the individual opinion of the Governor of Yemen. *See also id.* at 2 (describing some useful edicts of Islam that are pertinent to this discussion: (1) the Qur'an represents the verbatim revelation of God to the Prophet and it is authoritatively explained through the *Sunnah*; (2) Islamic law, the Shari'ah, originates directly from the Qur'an, the *Sunnah*, or indirectly from these sources as deduced through analogy or individual reasoning; (3) that which the law declares cannot be changed (*i.e.* prohibitions cannot be permitted, and things permitted cannot be prohibited) even if it is in direct opposition to logical reasoning; (4) if nothing is specifically prohibited by the law, then it is presumed to be permitted; (5) the concept of prosperity in Islam does not refer to the prosperity of man through the accumulation of surplus wealth, but rather to the pleasure of God, which can be achieved through good deeds and the purification of human behavior; (6) the Islamic concept of property, in the form of income or wealth, is not considered evil and is considered a means by which one can accomplish good deeds in serving God). HAMMAD, *supra* note 1, at 4-5 (providing a concise discussion of the facets of Islam).

which espouses the direct word of God. Should the Qur'an not address the situation clearly, the next level sought to address the situation is the tradition of the Prophet Mohammed. The next levels are consensus, analogy, and lastly individual reasoning.[22] Derived from this hierarchy of sources are the objectives of Islam, which are central to laying a foundation to understand Islamic banking and finance.

B. Objectives of Islamic Law

Probably the most telling reason for the difficulty non-Muslims have in understanding Islam and its legal framework is a lack of understanding that Islam is an all-encompassing 'way of life.' The sources of law relate precepts directly from God, which direct every aspect of the life of a Muslim.[23] So, in order to be a good Muslim, one must follow *Shari'ah* rules or the law in their totality. Since these precepts are essentially rules set down by God, directly telling each Muslim how to live his or her life, it is clear that the law governing Islamic society is more venerated than the rules based on man-made law. Once one understands the importance of religious law for Muslims, it is possible to get a deeper insight into what drives a Muslim to follow the many precepts of Islam even though from an outside perspective, they may seem unnecessary or even ridiculous.[24]

As a system of governance that ensures the emotional and financial success of the entire society, Islam is a goal-oriented religion based on the concept of oneness of God (*tawhid*).[25] Inherent in this concept is the idea that the totality of creation was the result of the power of one supreme being.[26] The next logical step in Islamic thought is that "the human being is the supreme being's *Khalifah* or vicegerent on earth (Qur'an 2:30; 6:165) and the resources at his disposal are a trust (Qur'an, 57:7)."[27] Since all human beings are *Khalifah*, it

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[22] It is important here to reiterate the hierarchy of *Shari'ah* sources because it helps to illustrate a significant difference between the Islamic and capitalist frameworks discussed below.

[23] *See* WEERAMANTRY, *supra* note 7, at 1. "Islamic law is based . . . on unqualified submission to the will of God. This is a fundamental tenet of the Islamic religion, and since Islamic law is based upon Islamic religion, it proceeds on the same fundamental assumption. The will of God embraces all aspects of life and the law hence covers all of them." *Id.*

[24] *See* JOSEPH SCHACHT, AN INTRODUCTION TO ISLAMIC LAW, 4-5 (1964) (suggesting that even though Islam is a "sacred law" it is not created "by an irrational process of continuous revelation but by a rational method of interpretation . . .").

[25] *See* AL-OMAR & ABDEL-HAQ, *supra* note 16, at 2-3 (articulating the goals of Islam).

[26] *See id.* (quoting QUR'AN 3:191; 38:27; 23:15).

[27] *Id.* at 3. Notions of property ownership in Islam are vastly different from those of traditional capitalistic societies. *See id.* The distinction is significant because Islamic notions

follows that the relationship between resources and man—that of a trust—applies to all human beings and exempts no particular class of individuals.[28] The universal applicability of *Khalifah* "stands essentially for the fundamental unity and brotherhood of mankind."[29]

In order to ensure that the ideals of *Khalifah* are preserved, the concept of justice or *adalah* is one of the most important tenets of the Islamic faith.[30] The unity of mankind and the importance of justice in upholding this unity underscores the fact that "the well-being (*falah*) of all human beings is the principal goal of Islam."[31] These concepts are central to gaining an understanding of the nature of Islamic banking and finance since they form the basis for the legal rules governing how Muslims use property to ensure societal well being, particularly in regard to the accumulation of wealth. Although individuals can and do accumulate wealth in Islamic societies, wealth maximization "must be accompanied by efforts directed to ensure spiritual health at the inner core of human consciousness, and justice and fair play at all levels of the human interaction."[32]

The legal rules in Islam that shape the behavior of producer and consumer, behavior central to the economic viability of any market, are structured in order to achieve these goals.[33] In Islamic societies, building on the idea of *Khalifah*, all property that exists in the world does not belong to man but instead belongs to God.[34] The property rights afforded to man in Islam enable man to use this property to acquire more possessions, but this use carries with it certain legal obligations.[35] In one scholar's words:

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of property are fundamental to the governance of banking and financial transactions in Islam.

[28] *See id.* (illustrating how the basis of Islam depends on the concept of unity).

[29] *Id.* The concept of *Khalifah* is contrary to capitalistic fundamentals, where individuality and success are fostered by an "every man for himself" mentality.

[30] *See id.*

[31] AL-OMAR & ABDEL-HAQ, *supra* note 16, at 3.

[32] *Id.*

[33] *See id.* at 5 (listing three points pertinent to the concept of property that are useful to grasp at this point in the discussion: (1) property is not owned by human beings, it is owned unconditionally by Allah, (2) property, therefore, is held in trust by all human beings and is conditional, (3) conditional ownership can be collective (such as natural resources) or individual (such as goods, buildings, and other things where one has the right to sell, lease, or rent)).

[34] *See id.*

[35] The principle of *Zakah* in Islam, although not directly associated with banking and finance, is one of the fundamental precepts of Islam. It serves to illustrate Islam's strong mandate towards social and economic equality in society. "Islam requires every Muslim, having resources in excess of a certain basic amount, to pay *zakah* as a given proportion of her or his net worth . . . in order to purify their wealth and their souls" by giving this portion to the poor and the needy. *Id.* at 6.

> Although individuals are allowed to own wealth in the normal way, the final aim is that this wealth should be of use to the community as a whole: social solidarity is the well-being of individuals and societies. Wealth can come into the possession of any individual through his or her work, or through inheritance and grants which are also conceived of originally as the results of work.[36]

III. THE PROHIBITION OF RIBA[37]

The concept of work in Islam is also a fundamental link in the rationale behind the *Shari'ah's* prohibition of interest, and it is one of the major themes throughout Islam that differentiates it from other religions and other economic systems.

> All forms of activities that allow an individual to acquire wealth in a haram [*i.e.*, forbidden by the Shari'ah] way are strictly prohibited. These include . . . hoarding, gambling and betting in all forms; cheating in quality, quantity, weight or any specifications of the goods and services traded or acquired or disposed of; all types of fraudulent sale or sales used as an excuse to charge interest, trade malpractices (for example, creating artificial scarcities); and interest in any form and at any rate.[38]

Simply stated, Islamic law prohibits interest because it fosters the accumulation of wealth that is not a product of work. That the concepts of work and unlawful gain in Islam are central to the life of every Muslim cannot be disputed.[39] The accumulation of wealth from interest is contrary to these fundamental ideals. For many in the non-Islamic world, however, it is difficult to grasp the importance of the prohibition because they may not have a clear understanding of where it originates or to what it refers.[40] Should this

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[36] *Id.* at 5.

[37] *See infra* note 49 and accompanying text for a discussion of the meaning of *riba*.

[38] *Id.* at 5-6.

[39] *See* MUHAMMAD IQBAL SIDDIQI, MODEL OF AN ISLAMIC BANK 9 (1986) (describing that the money gained in interest is not the consideration behind its ban, rather it is the fact that this money is not generated by labor, and that the wealth of a nation depends upon the collectivity of labor provided by its members).

[40] *See* DESEIFE, *supra* note 1, at 1 and accompanying text.

ignorance continue, partnership and understanding between the Islamic and non-Islamic world will surely be difficult, if not impossible.[41] The following discussion of the origin and the scope of the *Shari'ah* prohibition of interest should help foster a better understanding.

The Islamic prohibition of *riba* does not stem from benevolent notions, which put the welfare of society over that of individuals. The prohibition of interest is explicitly stated throughout the sources of Islamic law, most importantly in both the Qur'an and the *hadith*.[42]

The Qur'an specifically prohibits *riba* in at least eleven separate instances. For example, the Qur'an states, "[t]hat they took *riba*, though they were forbidden; and that they devoured men's substance wrongfully. We have prepared for those among them who reject faith, a grievous punishment."[43] The Qur'an goes on to say that "[t]hose who devour *riba* will not stand except as stands the one whom the evil one by his touch hath driven to madness. That is because they say: 'Trade is like *riba*.' But Allah hath permitted trade and forbidden *riba*. 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 offence) are companions of the fire; they will abide therein (forever)."[44] Another well-known verse states, "O ye who believe! [F]ear Allah and give up what remains of your demand for *riba*, if ye are indeed believers. . ."[45] The preceding verses illustrate the importance of *riba* in Islam because it is a subject that the Qur'an deals with directly.

There are many *hadith* that also address the prohibition of interest in Islam.[46] As stated above, the *hadith* are the sayings of the Prophet Muhammad and are found in the narratives of authorities on the subject.[47] One of the most telling narratives regarding this topic is from the authority Abu Hurayrah, which states: "[t]he Prophet, peace be upon him, said: 'On the night of Ascension I came upon people whose stomachs were like houses with snakes

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[41] *See id.*

[42] *See* SIDDIQUI, *supra* note 4, at 9-10.

[43] QUR'AN 4:161, *in* SIDDIQUI, *supra* note 4, at 9.

[44] QUR'AN 2:275, *in* SIDDIQUI, *supra* note 4, at 9-10.

[45] QUR'AN 2:278, *in* SIDDIQUI, *supra* note 4, at 10 (listing these and other verses of the Qur'an applicable to the prohibition of *riba*). Siddiqui also addresses the interest versus usury controversy stating that *riba* refers to anything that exceeds the principal amount, whether interest or usury. *See infra* note 49 and accompanying text.

[46] *See* SIDDIQUI, *supra* note 4, at 14.

[47] *See supra* pp. 157-59.

visible from the outside. I asked Gabriel who they were. He replied that they were people who had received *riba.*' (Musnad Ahmed)."[48]

Though the prohibition is express and comes directly from the sources of Islamic law, it nevertheless creates an ambiguity regarding the exact meaning of "interest." The Arabic term, *riba*, which literally means an increase or addition, encompasses the concept of "interest" in Islam.[49] Although this definition appears quite straightforward, the exact meaning of the word "*riba*" has been the subject of long-standing controversy in the Islamic world.[50] In its basic form, the heart of the controversy is that, because of differing interpretations of the Qur'an, it is difficult to determine to what *riba* actually refers.[51] Does it refer to interest or to usury? The distinction is an important one, for if *riba* is taken to mean only usury, then only those transactions, which involve an unjust and illegal collection of interest are forbidden. The lawful charging of interest in Islam, therefore, would be permitted under this interpretation. The general consensus among Muslim scholars is, however, that a strict interpretation of *riba* should be used, and therefore, all forms of interest, whether lawful (in the form of interest) unlawful (in the form of usury), are prohibited.[52]

For example, S.H. Amin notes that there is textual evidence in the Qur'an that the term *riba* refers to the medieval Arabian practice of doubling and even quadrupling the money owed by a debtor in the case of default, *i.e.*, usury.

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[48] SIDDIQUI, *supra* note 4, at 14.

[49] *See id.* at 5; *see also* AL-OMAR & ABDEL-HAQ, *supra* note 16, at xvi (providing a technical definition of *riba* as "an increase which is a loan transaction or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value or recompense (*'iwad*) in return to the other party; every increase which is without an *'iwad* or equal counter-value"); *Cf. infra* p. 61 and note 96 (providing the definition of *riba* is doubt, suspicion, and misgiving).

[50] *See* TRAUTE WOHLERS-SCHARF, ARAB AND ISLAMIC BANKS NEW BUSINESS PARTNERS FOR DEVELOPING COUNTRIES 75-76 (1983). This controversy is likely one of the most significant factors contributing to the lack of a standard form of Islamic banking since the many different interpretations of the term *riba* have contributed to the numerous methods of banking and finance throughout the Islamic world.

[51] *See id.*; *see also* SIDDIQUI, *supra* note 4, at 71 (describing the opinion of fundamentalist Muslims that interest in any form, for investment or consumption purposes, is prohibited by the Qur'an in order to effectively prevent exploitation of the debtor by the creditor), 6-7 (stating that originally, the word "usury" referred to lending money at interest, but its meaning evolved to denote the practice of illegally receiving interest for money given as a loan. Siddiqui also discusses the history of definitions of usury and he ultimately concludes that the word *riba* refers not to usury but to interest).

[52] *See* AMIN, *supra* note 9, at 25.

Amin, however, concludes that the latest verses of the Qur'an leave no room for a liberal interpretation and the term *riba* refers to all forms of interest.[53]

IV. ISLAMIC BANKING AND FINANCE

Both the sources of law regarding the prohibition of *riba* and interpretations of the prohibition that call for its universal application show that *riba* is in direct conflict with Islamic ideals and precepts. As previously noted, *riba* conflicts with concepts such as *Khaifah*, *Zakah*, and work, which are essential to the socialist nature of the religion.[54]

Much of the confusion that arises in the non-Islamic world regarding Islam's interest prohibition is based on an isolated view of the prohibition. In other words, unless the totality of Islam as a religion is taken into account, an analysis of *riba* from a peripheral perspective will remain inadequate.[55] The above examination of the goals of Islam, the specific textual prohibitions of *riba*, and interpretations regarding its application to all forms of interest should provide the foundation for a sufficient understanding of Islamic banking and finance.

With a deeper understanding, it is possible to move into a specific analysis of the need for Islamic banking, its principles, and the alternative methods of banking that arise out of these principles. Such an analysis will illustrate that Islamic and non-Islamic systems of banking can not only co-exist, but also can benefit from one another.

A. *The Need for and Principles of Islamic Banking and Finance*

The Islamic banking and finance movement is the result of a recent resurgence felt throughout the Muslim world, one that emphasizes a stricter adherence to the *Shari'ah* in all areas of governance.[56] According to some, this

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[53] *See id.* Since this is the general consensus of Islamic scholars, from this point forward the term "*riba*" as used in this discussion will refer to interest and not to usury.

[54] *See supra* pp. 159-61 for an elaboration of the concepts of *Khalifah, Zakah,* and work in Islam.

[55] *See* AL-OMAR & ABDEL-HAQ, *supra* note 16, at 9 (stating that "[d]ifficulty in understanding the prohibition arises from lack of appreciation of its place in the whole context of Islamic values, and particularly Islam's uncompromising emphasis on socio-economic justice. Any attempt to treat the prohibition of rib[a] as an isolated religious injunction and not as an integral part of the Islamic economic order with its overall ethos, goals, and values is bound to create confusion").

[56] *See* KHAN, *supra* note 8, at 7.

resurgence in religious conservatism is largely the result "of a long prevailing identity crisis being experienced by Muslims. The self-pride of Muslims that came from having been conquerors and rulers for over a millenium [sic] was battered by the shocking reality of Western military and technological superiority."[57] This sociological phenomenon can be explained in the context of Islamic history. Once the prohibition of *riba* came into conflict with the current modes of banking and finance (which were based on Western models), devout Muslims were, and continue to be, extremely embarrassed.[58] The ban on interest had a limited effect as evidenced by the variety of legal loopholes (*hiyal*) that were created to get around the ban.[59] More importantly, "most non-Muslims writing on Islamic law saw only this negative aspect of the matter and were prompt to tax Muslims with shallowness and religious hypocrisy."[60] Furthermore, the success of socio-economic ideologies such as capitalism has contributed to this weakened self-pride.[61] Perhaps in an attempt to develop a strong Muslim identity, Muslim communities have reacted through the current Islamic banking and finance movement and its attempt to strictly comply with the *Shari'ah*.

Though the goal of strict compliance is clear, there are significant problems regarding its implementation. As previously mentioned, the Islamic system of banking and finance was based on capitalistic models of interest-based banking.[62] Though there was a strong resurgence in the revival of Islamic values, Muslims were hard-pressed to find a "quick fix" to the problems associated with following practices that did not comport with the *Shari'ah*.[63] In a sense, Muslims were put in an inherently unfair position because of the unrealistic expectation that they refrain from involvement in *riba* transactions because the ruling economic order of the time was interest-based. The Islamic world, consequently, needed an entirely new system that was wholly based on the values and goals of Islam.

This need led to the problem of ascertaining a method of banking and finance that would provide similar incentives to those of interest-based

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[57] *Id.*

[58] *See* NABIL A. SALEH, UNLAWFUL GAIN AND LEGITIMATE PROFIT IN ISLAMIC LAW: RIBA, GHARAR, AND ISLAMIC BANKING 107 (1992).

[59] *See id.*

[60] *Id.*

[61] *See* KHAN, *supra* note 8, at 8.

[62] *See supra* note 9 and accompanying text.

[63] *See* SALEH, *supra* note 58, at 108 (noting that "[c]apitalism cannot be Islamized simply by abolishing interest and aleatory transactions; new proposals were needed, but unfortunately were not forthcoming").

banking alternatives (*i.e.*, incentives for both the lender and borrower to enter into banking transactions) while also strictly adhering to the *Shari'ah*. As previously mentioned, Islam encourages the accumulation of wealth so long as it is used for the benefit of society as a whole in conformance with Islam's objectives.[64] Outsiders unfamiliar with the Islamic paradigm may think it impossible to effectively administer an interest-free system of banking and finance because of the broad application of the term interest.[65] After all, anything above the amount of the principal could be considered interest, and as such, it might be prohibited under the *Shari'ah*. This view, however, is overly narrow since it does not take into account the fact that the Islamic system values capital when it is the product of work.[66] It should also be noted that the term 'work' carries a broad connotation and includes the idea of risk, which is fundamental to the effective operation of Islamic banking and finance methods. "To put it differently, investors in the Islamic order have no right to demand a fixed rate of return. No one is entitled to any addition to the principal sum if he does not share in the risks involved."[67] Thus, the basis for Islamic banking and finance transactions is the principal of shared risk allocation.

As a general matter, for both parties in a financial transaction to receive any benefit in addition to the principal amount invested, they must share the risks

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[64] *See* AL-OMAR & ABDEL-HAQ, *supra* note 16, at 2; *see also* SIDDIQUI, *supra* note 4, at 47-48 (outlining the principles and objectives of the Islamic economic system as:

> (i) Sole purpose to obey and please Allah; (ii) The wealth and assets in all their forms are given under trust by Allah; (iii) Moral values are guiding factors for all economic activities; (iv) Maximum and equitable utilization of human and material resources given by Allah; (v) human dignity and respect for labour; (vi) Maximum freedom for economic activity within a just framework; (vii) equitable distribution of wealth and income and disciplined private ownership; (viii) Simplicity, economy and austerity in expenses; (ix) *Adl* and *Ahsan* (Justice and Kindness); (x) Strict prohibition of *riba*, interest and usury in all forms.

Id.

The aims of the Islamic economic system are to: "(i) ensure socio-economic justice; (ii) bring optimum allocation of resources; (iii) encourage savings and capital formation; (iv) check inflation; (v) bring stability in the value of money and exchange rates; (vi) ensure economic efficiency and accelerated rate of growth; (vii) ensure broad-based economic well-being, balanced monetary expansion and full employment."). *Id.*

[65] *See* SIDDIQUI, *supra* note 4, at 53.

[66] *See* AL-OMAR & ABDEL-HAQ, *supra* note 16, at 6.

[67] *See* Mohamed Ariff, *Islamic Banking*, 2:2 ASIAN-PACIFIC ECONOMIC LITERATURE 46 (Sept. 1998) (visited Jan. 22, 2001) <http://www.usc.edu/dept/MSA/economics/islamic_banking.html>.

involved in the transaction.[68] In other words, ". . . an Islamic bank should share in the risk with the entrepreneur which is in sharp contrast with the interest-based bank. Islamic banking implies zero rate of interest but not zero rate of return as Islamic banks do not deal in money but deal with money."[69] This general idea of shared risk allocation buttresses the viability of the Islamic economic model, and it also gives rise to a number of banking methods that have been employed in an attempt to provide *Shari'ah*-compliant alternatives to traditional banking.[70] One can better understand such alternative methods by tracing the evolution of Islamic banking from its inception to its present state.

B. The Islamic Banking Movement

The beginning of the establishment of a new system of banking and finance was undertaken in the Egyptian town of Mit Ghamr in 1963.[71] The "Egyptian experiment," as it is often labeled, established a savings bank based on the idea of profit sharing.[72] In 1967, the Mit Ghamr bank was closed for political reasons, but its brief success was the spark that ignited the Islamic banking movement.[73] There were several banks that followed the Mit Ghamr bank by providing financial services without charging interest.[74] In 1971, then—Egyptian President Anwar Sadat established the Naṣir Social Bank, which was an interest-free commercial bank.[75] As a result of the establishment of this bank, Egypt actively influenced the rest of the Islamic world to do the same. In 1972, Egypt submitted a study of Islamic banking to the Islamic foreign ministers' conference, which influenced the organization to establish an intergovernmental Islamic Development Bank (IDB).[76] The IDB opened in 1974, but its services were limited to the provision of funds for development projects in member countries.[77]

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[68] *See* SIDDIQUI, *supra* note 4, at 49.
[69] *Id.*
[70] *See id.* (defining an Islamic bank as a financial institution that is governed by Islamic law in its objectives, practices, operations, and principles. Siddiqui notes that Islamic banks are not in the business of lending money, except in the form of interest-free loans (*Qard Hasan*) as they act as partners with those who use their services).
[71] *See* AL-OMAR & ABDEL-HAQ, *supra* note 16, at 21.
[72] *See* Ariff, *supra* note 62.
[73] *See* NIENHAUS, *supra* note 10, at 5-6.
[74] *See id.*
[75] *See id.*
[76] *See id.*
[77] *See* Ariff, *supra* note 67.

Due to the changing political climate of many Muslim countries, the late 1970s and early 1980s saw a dramatic increase in the number of Islamic banks.[78] The establishment of banks throughout the Middle East, such as the Dubai Islamic Bank (1975), the Faisal Islamic Bank of Sudan (1977), the Faisal Islamic Bank of Egypt (1977), and the Bahrain Islamic Bank (1979), proved that the Islamic banking movement was not just a meager attempt to revive Islam.[79] It is notable that there were only five Islamic banks in 1975, a number that rose to twenty-five in 1980 and an impressive sixty-seven in 1989.[80] The banks have flourished, and in fact, thirty-one banks are now members of the International Association of Islamic Banks.[81]

As mentioned earlier, Islamic values place a premium on capital because it is one of the means by which the goals of Islam can be accomplished. Since the *Shari'ah* forbids capital that is not the product of work (*i.e.*, *riba*), Islamic banks were forced to establish an alternative method of capital production. At the same time, they had to ensure compliance with the *Shari'ah*. The dilemma facing Islamic banks is typified in the following statement: "there is no clear consensus on what form the alternative to the interest rate mechanism should take. The issue is not resolved and the search for an alternative continues, but it has not detracted from efforts to experiment with Islamic banking without interest."[82] Out of this state of confusion, there are several modes of operation that Islamic banks developed in order to conduct banking and finance transactions in compliance with the *Shari'ah*.

C. Methods of Banking and Finance Developed for Shari'ah Compliance

In order to provide interest-free banking and financial services to the Muslim community, Islamic banks practice certain methods within defined areas of operation.[83] Shahid Hasan Siddiqui delineates the three general areas of operation for Islamic banks as (1) non-fund transactions, (2) investment activities, and (3) social activities.[84]

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[78] *See id.* (suggesting that the initial Islamic financial institutions operated under a cover because they did not want to project an Islamic image due to negative world attitude towards Islamic fundamentalism and noting that the charters establishing the banks made no mention of the *Shari'ah* or Islam).

[79] *See id.*; *see also* SIDDIQUI, *supra* note 4, at 51.

[80] *See* SIDDIQUI, *supra* note 4, at 51

[81] *See id.*

[82] Ariff, *supra* note 67.

[83] *See* SIDDIQUI, *supra* note 4, at 52-54.

[84] *See id.* at 52 (describing the social activity operation of Islamic banks as *Qard Hasan*,

Non-fund transactions are similar to the service-oriented transactions of conventional banks. Transactions from current accounts, savings accounts, and investment accounts are generally considered non-fund transactions.[85] In these accounts, the bank does not give interest, and they are, in essence, "a safe-keeping (*al-wadiah*) arrangement between the depositors and the bank, which allows the depositors to withdraw their money at any time and permits the bank to use depositors' money."[86]

Investment activities (which are the most pertinent to this discussion) involve the use of a variety of mechanisms in order to gather financial resources and to provide capital financing to "provide finance for trade, industry, and agriculture."[87] The most commonly used modes of investment activities in Islamic banking are *mudaraba*, *musharaka*, *murabaha*, *bai'muajjal*, *ijara*, and *bai'salam*.[88]

Mudaraba is generally equivalent to the type of transaction in conventional finance known as venture capitalism. *Mudaraba* allows the entrepreneur with a business plan to make use of an investor's capital.[89] Here, the owner of capital, *i.e.*, the investor, shares in the profit earned by the entrepreneur and bears any losses on his own. The scheme designates the entrepeneur as a type of agent for the investor or investors so that those owning the capital entrust the entrepeneur with it.[90] In exchange for the use of the capital, the entrepeneur agrees to give a specified share of future profits to the investors, who in turn are exclusively responsible for any loss to the capital while in the care of the entrepeneur.[91]

Though this arrangement seemingly circumvents the prohibition of *riba*, it appears in conflict with the notion of equal risk allocation. After all, only the owner of capital assumes the risk of loss while both share in the venture's profits. Perhaps, the discrepancy in loss can be justified by the fact that the borrower in a *mudaraba* transaction risks the loss of his time and effort so that the two parties are not simply profit-sharing, but "profit and loss sharing."[92]

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which refers to loans the bank gives for non-commercial activities such as marriage or education. *Qard Hasan* will not be a subject of focus in this discussion).

[85] *See* Ariff, *supra* note 67.

[86] *Id.*

[87] SIDDIQUI, *supra* note 4, at 52.

[88] *See* Ariff, *supra* note 67.

[89] *See id.* (the owner of capital is referred to in Arabic as the *rabbul-mal*, literally the "owner of the capital." The entrepreneur borrower is known as the *mudarib*); *see also* KHAN, *supra* note 8, at 49.

[90] *See* KHAN, *supra* note 8, at 49.

[91] *See id.*

[92] *Id.* at 64.

In this manner, both investor and entrepeneur benefit from a transaction in which one risks loss of capital while the other risks loss of the more metaphysical capital—that of time and effort. To further add to its appeal, the *mudaraba* transaction was approved and practiced by the Prophet, according to Islamic jurists.[93]

Another alternative to interest based investments is *musharaka,* the Islamic equivalent of the capitalistic partnership arrangement.[94] In the *musharaka* transaction, partners contribute capital to the partnership, sharing profits and losses according to an agreed-upon formula based on the contribution of each partner.[95] Islamic banks are involved in both *mudaraba* and *musharaka* transactions. In a *mudaraba* transaction, the bank acts as a *mudarib,* or borrower, managing the funds of the depositors to generate profits.[96] It thereby operates on a "two-tier *mudaraba* system in which it acts both as the *mudarib* on the saving side of the equation and as the *rabbulmal* on the investment portfolio side."[97] Further, the bank may also enter into a profit and loss sharing scheme with its customers according to the *musharaka* formulation by using deposited funds.[98]

The *mudaraba* and *musharaka* modes of finance theoretically constitute the primary methods of financing in Islamic banking, but in practice, they are considered quite risky. As a result, other less risky methods are used more often.[99] One of the most commonly used methods of financing is the *murabaha,* or financing on a "cost plus" basis.[100] In this method of finance, the bank purchases a good on behalf of its customer and then resells it to the customer at a higher price. Although this mode of finance appears to permit interest under disguise, it is a permissible form of finance because "[t]he bank's profit premium is justified by the risk it incurs by allowing the client to refuse to accept a commodity procured on their behalf by the bank."[101]

Another mode of financing commonly used by Islamic banks is *bai'muajjal,* which involves the purchase and resale of property for a higher price on a delayed payment basis.[102] Like *mudaraba,* on the surface, this

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93 *See id.*
94 *See* Ariff, *supra* note 67.
95 *See id.*
96 *See id.*
97 *Id.*
98 *See id.*
99 *See id.*
100 *See* SIDDIQUI, *supra* note 4, at 52.
101 KHAN, *supra* note 8, at 64.
102 *See* Ariff, *supra* note 67.

system looks like a loophole circumventing the *riba* prohibition. It is justified in Islamic jurisprudence (*fiqh*), however, because it is considered a trading transaction rather than a lending one.[103]

Ijara is yet another form of finance that does not involve *riba* and is commonly used by Islamic banks when equipment and machinery are involved.[104] In the *ijara*, or lease transaction, the bank is the owner of the machinery or equipment and the clients pay a fixed amount for its use.[105] The lessee can buy the equipment from the bank and thus the installments would include both the rental and purchase fees of the equipment.[106]

One of the final methods of financing used by Islamic banks where the sale of goods is involved is known as *bai 'salam*.[107] In a *bai 'salam* transaction, the goods purchased are paid for in advance at the time of execution of the contract. But, delivery of the goods is delayed until a later date.[108] "This mode enables an entrepreneur to sell his output to a bank at a price determined in advance."[109]

It is clear from the above modes of financing that Islamic banking has established creative methods of financing in order to foster economic growth within the Muslim community without compromising the goals of Islam. In fact, these methods foster the goals of Islam. Although these methods represent the majority of financing methods in Islam, they are by no means exhaustive, nor do they represent the outer limits of the development of other alternatives to traditional modes of banking and finance. Furthermore, as critics within the Islamic community dissect the methods in terms of *Shari 'ah* compliance, there is the possibility that the methods may change. In fact, several of these methods have spawned controversy because a minority of Muslims consider some of these methods as mere pretexts, disguising the use of interest.[110] For example, one critic notes that

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[103] *See id.*

[104] *See id.*

[105] *See id.*; *see also* AL-OMAR & ABDEL-HAQ, *supra* note 16, at xii (defining *ijara* as "an arrangement under which the Islamic bank leases equipment, a building or other facility to a client, against an agreed rental. The rent is so fixed that the bank gets back its original investment plus a profit on it.").

[106] *See* Ariff, *supra* note 67.

[107] *See id.*

[108] *See* AL-OMAR & ABDEL-HAQ, *supra* note 16, at xi.

[109] *See* Ariff, *supra* note 67.

[110] *See* SIDDIQUI, *supra* note 4, at 53.

> [i]t is important to appreciate that most of the modes of financing being practiced as a replacement of interest do not contribute fully in achieving the socio-economic objectives as envisaged by Islam. Further, these modes of financing, in some cases, seem to guarantee a fixed rate of return and no risk is practically shared by the financier with the entrepreneur.[111]

Although this may be the case, the fact is that these methods, with their pros and cons, are a part of the current state of Islamic banking. While these methods may change over time, it is important for those in the non-Islamic world dealing with the Islamic market to both operate under the current system and stay focused and flexible should these modes change in the future.

V. THE EFFECT OF INTEREST ON CAPITALISM VERSUS ITS EFFECT ON "ISLAMISM"

The current financing methods used by Islamic banks are helpful in clarifying many issues that obfuscate the necessary understanding that non-Islamic countries need in order to achieve economic cooperation with the Islamic world. It should be apparent by now that not only are interest-free financial solutions available, they are very much successful. However, a comprehensive understanding of Islamic banking and finance would not be complete without a comparative analysis of the two systems. The following comparison between capitalist systems and the Islamic financial system, as they apply to interest, should contribute to this comprehensive understanding.

A. Differences in the Sources of Law

The most appropriate starting point for a comparison between the two systems and one that yields a great deal of differences, is an examination of the origin of the law. The sources of law in Islam are fundamentally different from those of most countries that operate under a capitalist paradigm.[112] The legal tradition of the West is wholly dependent upon the individual reasoning of judges, jurists, legal scholars, and the like.[113] For instance, in countries that adopt a common law approach, a particular class of individuals makes the law,

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[111] *Id.*
[112] *See supra* note 8, at 5-7.
[113] *See* ALAN WATSON, THE EVOLUTION OF WESTERN PRIVATE LAW 75 (1999).

and the law evolves based on the opinions of those individuals as applied to particular circumstances.[114] The *Shari'ah*, however, puts little faith in man's ability to reason, which is evidenced by the fact that governance through individual reasoning is an option only in the last resort.[115]

Another marked difference between the Islamic system and its Western counterpart is evidenced in the relationship between the practice of Islam and economics. Unlike many societies based on a capitalistic paradigm, where economics and religion are distinct entities, Islam cannot and does not separate religion from economics or from any other aspect of society. Islam is not only a religion, but also a system of governance. In fact, concepts in the West, such as separation of church and state in the United States, are in direct opposition to the objectives of Islam. Islam is a religion that permeates every aspect of the life of a Muslim, and countries ruled by the *Shari'ah* must adhere to this permeation. The *Shari'ah* is not only a mandate from God on how to live one's life individually, but also is a command on how individuals are to live collectively in a society. It is vital to understand this philosophical divide between the West and the Islamic world. After all, without this basic appreciation of the Islamic world view, it is impossible to have an actual insight into the system.

B. Conceptual Differences of Interest

The next point of comparative analysis is the differences in the conception of interest between the two systems. As previously mentioned, to the capitalist West, a mode of banking and finance absent the concept of interest is a virtual impossibility. In a capitalistic society, the ability for one to reap profit from investment is the most valued concept of economics. This profit is almost always in some form of interest.[116] The incentive to invest in a mutual fund, for instance, is that the principal amount of money invested will over time yield a value equal to a certain percentage rate of the initial investment, *i.e.*, interest. Likewise, when a bank loans money to an individual, it does so on

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[114] *See id.*

[115] *See supra* note 8, at 5-6 (regarding the places of *ijma'* in the hierarchy of sources of Islamic law).

[116] It is interesting to note the distinctions in connotation between the literal meaning of the word "interest" in English and the Arabic word for interest, *riba*. Interest in English carries a beneficial connotation whereas the definition of *riba* has a negative one. *Compare* WEBSTER'S DICTIONARY 197 (12th ed. 1986) (defining interest as the profit percent from the money lent) *with* THE HANS WEHR DICTIONARY OF MODERN WRITTEN ARABIC, 370 (3d ed. 1976) (defining *riba* as doubt, suspicion, and misgiving).

the basis that it will receive profit by adding a certain percentage of money to the amount of the initial loan to be repaid, which is also interest.

Indeed, the very entrepreneurial spirit of a capitalist society is wholly dependent on the concept of interest. It would be very difficult to imagine how the United States,[117] a country that epitomizes capitalism, could survive if lending institutions were not given an incentive to make funds available to those who dream of owning their own businesses. In fact, interest is so pivotal a concept to the capitalist system that a mere statement one way or the other regarding the raising or lowering of interest rates by Federal Reserve Chairman Alan Greenspan has the potential of crippling the entire economy.[118] Many Americans have such a significant amount of capital invested in interest-bearing accounts such as stocks, bonds, mutual funds, and savings accounts, that any minor fluctuation in the rates of interest could have an extremely damaging impact.[119] These views of interest are in direct opposition to Islamic fundamentals of banking and finance that strictly prohibit interest.[120] In his book, Siddiqui illustrates this point by noting that the vast amounts of capital attained by banks from millions of depositors (the small players in the system) are being given to only a small percentage of the population (the big players in the system).[121]

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[117] Specific examples regarding the effect of interest on capitalistic societies in this discussion will focus on the United States as a primary example.

[118] *See Do Mr. Greenspan and the Federal Reserve Know What Really Causes Inflation?* (visited Jan. 28, 2000) <http://www.internetfreepress.com/articles/grenspan.htm>. "What Greenspan, the Federal Reserve and Wall Street do not understand is that an increase in interest rates is, in itself, the very essence of inflation. When the cost of borrowed money climbs one-quarter . . . one-half a percentage point, the increase filters down to every facet of our economy. It causes a rise in every consumer product and service. Increasing the interest rates to dampen inflation is like pouring gasoline on a raging fire to extinguish the flames." *Id.*

[119] *See* Fred Vogelstein, *Do Worry. Be Unhappy* (visited Jan. 28, 2000) <http://www.usnews.com/usnews/issue/990308/8haik.htm>.

[120] *See* SIDDIQUI, *supra* note 4, at 71.

> It appears that the Western world is still looking at the Islamic system with scepticism [sic]. There is, therefore, a need that they are made to understand it with an unbiased mind and without preconceived notions and give the Islamic banking system a fair chance to prove that it aims at the welfare of human beings and is practicable. The fact of the matter is that under the capitalist system, the gap between the haves and the have nots is widening. This creates problems and even hatred. Islam firmly believes in social justice. The principle of social justice is also accepted and recognized in the capitalist system, but in practice is totally different.

Id.

[121] *See id.*

C. Comparisons from a Characteristic Perspective

The significance of these conceptual differences lies in the fact that it is the very differences which establish the divergence between the two systems and make economic cooperation difficult. A comparison between the two systems that goes beyond conceptualism will show that the differences can be overcome and that economic cooperation between the Islamic system and capitalism is attainable. A useful study that is applicable to the present comparative analysis involves a comparison of characteristics that can be generally found in all economic systems.[122] The eight factors used in the study are (1) the level of economic development of the system, (2) the resource base, (3) the ownership-control of the means of production, (4) the locus of economic power, (5) the motivational system, (6) the organization of economic power, (7) the social process for economic coordination, and (8) the distribution of income and wealth.[123] When the comparison is viewed from this perspective, there are surprisingly few differences. The major differences are in the motivational system, the organization of economic power, and the distribution of income.[124]

The motivational system is defined as indicating the "criteria which actually and presumably guide the decision making of economic decisions, especially with regard to incentive for production and for reacting to changes in economic variables."[125] The capitalist motivational system is "market-oriented . . . with particular emphasis on profit motive."[126] The Islamic motivational system is similar except that the profit motive is guided by moral and spiritual concerns rather than the market.[127]

This suggests that both systems are oriented towards the attaining of profit, though for different purposes. The capitalist system seeks profit not as a means, but as an end that will satisfy the individual, while the Islamic system uses profit as a means to achieve its spiritual ends. Viewed from this perspective, it seems that this difference is not insurmountable. Indeed, both

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[122] *See* AHMED ABDEL-FATTAH EL-ASHKER, THE ISLAMIC BUSINESS ENTERPRISE 63-67 (1987) (stating that predominant factors of economic systems are used to compare Islamic economics with capitalism).

[123] *See id.* at 63-64 (providing an explanation of each of the factors).

[124] For purposes of this discussion, only those characteristics that show significant differences will be noted here. For a full analysis of the similarities and differences between the two systems, see *id.* at 64-67.

[125] *Id.* at 64.

[126] *Id.* at 65.

[127] *See id.* at 66.

systems can cooperate very well to achieve a profit. Once they attain profit, they can then use it for their respective differing purposes.

Next, the organization of economic power refers to "centralization versus decentralization with regard to government administration."[128] In the capitalist system, this factor is characterized by a vast discretion of individual choice and a highly decentralized government administration.[129] The Islamic system is similar, but it adds restricted areas for the choice of businesses that harm society's interests. After all, "[t]he general objective of Islamic banks is to develop the economy within and according to Islamic principles. In no eventuality, therefore, can such banks engage in the alcoholic beverage trade . . ."[130] Again, this difference can be overcome by keeping in mind that cooperation between the two systems in regard to the formation and financing of business must be done by respecting the Islamic societal interests imposed by the *Shari'ah*. A clear example of a breach of respect would be the case of a business venture between the two systems that either directly or indirectly financed the alcohol trade. This would be a clear violation of the interests of the Islamic society and, as such, the transaction should not happen.[131]

The third major difference between the two systems is the criterion of distribution of income, which "distinguishes systems according to how people obtain their income (labour, capital) and to the degree of inequality in income, property and/or opportunity."[132] Distribution of income in the capitalist system is described as "distribution according to market-determined contributions to production, with the possibility of considerable inequality in income and property."[133] The Islamic system is quite different and is characterized by "equitable distribution of income and decentralisation of wealth in the society with a recognition of differences in individuals' wealth."[134] Though this presents a significant difference between the two systems, it is evident that the differences only affect intra-system societal administration. In other words, cooperation is possible between the two systems to yield profit (which is desirable in both systems), and then each system can administer or not administer the fate of such profits wholly independent of one another. Hence, this difference should not be a limiting factor regarding the ability of the two systems to transact business.

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[128] *Id.* at 64.
[129] *See id.* at 65.
[130] AL-OMAR & ABDEL-HAQ, *supra* note 16, at 24-25.
[131] *See id.*
[132] EL-ASHKER, *supra* note 122, at 64.
[133] *Id.* at 65.
[134] *Id.* at 66.

This form of comparative analysis is useful in diluting the minutiae that arise when examining the issue of cooperation and understanding between entities that are based on opposing systems. The distilled essence of this analysis is that though there are significant differences between the two systems in areas such as the sources of the law, the meaning of interest, the societal objectives involved, and the characteristics of the systems, the divergence is not so significant as to preclude co-existence and cooperation of the two systems in a global economy. Given this conclusion it is now appropriate to discuss whether "Mohamed's Fantastic Falafel" could survive in an interest-free financial market such as that of Iran.

VI. CAN "MOHAMED'S FANTASTIC FALAFEL" SURVIVE UNDER AN ISLAMIC BANKING AND FINANCE SYSTEM?

This discussion began with the hypothetical situation of Mohamed and his restaurant, "Mohamed's Fantastic Falafel," where many questions arose regarding the ability for this type of entrepreneurial spirit to survive in an interest-free market. These concerns, which stemmed from a capitalistic view of Islamic banking and finance, should not pose a problem because of the availability of current methods of banking and finance in the Islamic world.

It is clear that Mohamed, using several of these financing methods, could have realized his dream under the Islamic banking and finance system now existing. For instance, the *mudaraba* transaction could have financed his venture interest-free. As previously mentioned, Mohamed, as entrepreneur, would use the capital of the *rabbul-mal* or investor to finance his business. He would then share the profits with the *rabbul-mal*, and both parties to the transaction would be satisfied—much like the result under the capitalist system.[135] Furthermore, the goals of Islam, under this transaction, have been satisfied. Mohamed can use his wealth as a means to satisfy the beneficent goals of the Islamic faith such as *Zakah*.[136]

Under the *musharaka* financing method, Mohamed could combine his capital with that of a lender, thereby forming a partnership in which they would share the profits of the restaurant commensurate with the amount of capital invested by each partner.[137] Again, Mohamed could both achieve his goal of becoming a successful entrepreneur while also satisfying the obligation he has to God and his faith.

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[135] *See* Ariff, *supra* note 67.
[136] *See supra* note 35 and accompanying text.
[137] *See* Ariff, supra note 67.

As mentioned above, there are many financing methods used by Islamic banks to finance these types of transactions. What is more important for purposes of this discussion, however, is to emphasize the fact that these types of transactions in an interest-free market, which at the beginning of the discussion were impossible when examined from a capitalist perspective, are not only possible but highly effective. Some might argue that the Islamic system is more effective in preventing the social ills associated with a capitalist society.[138] Though these arguments are thought-provoking, they may tend to distract from the main focus that these independent systems governing the financial markets of their respective societies can co-exist and benefit from one another, albeit in different ways.

VII. CONCLUSION

The recent resurgence and strong desire on the part of many Islamic countries to strictly adhere to the *Shari'ah* has affected the area of banking and finance in a dramatic way. This effect not only has implications within Islamic countries, but the ripple of the Islamic banking and finance movement can be felt throughout the world. During this time of economic globalization, when world economies can no longer operate independent of one another, it is extremely important that non-Islamic countries learn to transact business with the Islamic world, or they will suffer the consequences of economic isolationism.

Many Islamic countries have gained economic prominence in recent years and are now able to influence the world economy in ways that were previously out of their reach. The interest-free banking systems espoused by a continually growing Islamic banking movement pose difficulties for capitalist countries, in particular, because an interest-free system of banking and finance is so antithetical to the ideals of their system. However, it is still extremely important for the viability of their individual economies, as well as the global economy, that the West realize how to economically cooperate with their Islamic counterparts.

This goal can be achieved only if the problem is looked at objectively and free from misconceptions involved in making value judgments regarding the precepts of Islam. A clear understanding of Islam and its prohibition against

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[138] *See* SIDDIQUI, supra note 4, at 38-40 (advocating a basic needs argument in favor of the proposition that the Islamic system, while not as economically expansive as the capitalist system is, however, more effective because it reduces the social ills normally associated with capitalism).

interest should provide the necessary perspective. This understanding can be gained by acquiring knowledge regarding the history of Islam, the sources of law that govern the prohibition of interest, the fundamentals and objectives of Islam, the alternative methods of banking and finance created by the Islamic movement, and finally through an objective comparison of the capitalist and Islamic systems. As the preceding discussion illustrates, the combination of these factors with an objective view strongly suggests that economic cooperation between the two systems is possible.