**Student ID:**

**COURSEWORK 1**

**HOW DOES THE BAN ON RIBA INFORM THE DESIGN OF FINANCIAL PRODUCTS IN ISLAMIC FINANCE?**

Riba is derived from the derivative word ‘ribawa’ meaning ‘to increase, to grow; to grow up, to exceed, be more than’. riba is generally translated into English is usury or interest but in fact it has much broader sense under Shari’ah.[[1]](#footnote-0)

Riba is a concept in Islam that refers broadly to the concept of growth in, increasing or exceeding. The term “riba” has also been roughly translated as the pursuit of illegal, exploitative gains made in business or trade under Islamic law.[[2]](#footnote-1)

Technically or legally, riba has been defined as an increase of capital whether in loans or in an exchange of a commodity accrues to the owner [lender] without giving in return any equivalent counter-value or recompense [‘iwad] to the other party. *Iwad* is the basic trait or the condition of a halal or lawful sale because sale or exchange is necessary an exchange of value, against an equivalent value, an equitable return and compensation for the goods or services exchanged.[[3]](#footnote-2)

Riba was largely taken as law and formed the basis of the Islamic banking industry.[[4]](#footnote-3)

Riba was classified into two categories:

1. Riba al-fadi: The excess over and above the loan paid in kind. It lies in the payment of an addition by the debtor to the creditor in exchange of commodities of the the same kind.

Riba al-nasi’ah refers to the interest on loans; its prohibition essentially implies that the fixing in advance of a positive returns on a loan as a reward for waiting is not permitted in Islam.[[5]](#footnote-4)

Riba is prohibited under Shari’ah law for a couple of reasons:

1. It is meant to ensure equity in exchange
2. It is meant to ensure that people can protect their wealth by making unjust and unequal exchanges illegal.

‘The principal reason why Islam prohibits riba is that Islam wishes to establish an economic and social systems where all forms of exploitations are eliminated’.[[6]](#footnote-5)

Malik b. Anas wrote:

In pre-islamic days, riba became due when a man owed another a debt; at the time of its maturity, the creditor would ask the debtor: “will you repay or will you increase? If the debtor paid up, the amount was received. On the other hand, the debtor increased the amount and the creditor extended a further term”.[[7]](#footnote-6)

In trade, an entrepreneur has the prospect of making a profit , he also faces the risk of incurring a loss. Whereas, interest is predetermined to be positive irrespective of the ultimate outcome of the business which may be positive or negative depending to a great extent of factors beyond control of the entrepreneur.[[8]](#footnote-7)

While the earning of profit is uncertain, the payment of interest is predetermined and certain. This profit may or may not be realised. Hence, there can be no doubt that the payment of something definite in return for something uncertain inflicts a harm.[[9]](#footnote-8) The prohibition of riba alnasi’ah essentially implies that the fixing in advance of a positive return on a loan as reward for waiting is not permitted by the Shari’Ah. The waiting involved in the repayment of a loan does not in itself justify a positive reward.[[10]](#footnote-9)

Also, Islam prohibits interest due to the fact to reduce the concentration of wealth in the hand of few[[11]](#footnote-10) and to ensure fair and legitimate profit-making business activities.[[12]](#footnote-11)

Though Muslims agree that riba is prohibited but there is much debate over whether or not it should be punished by people or by Allah.[[13]](#footnote-12)

However, the prohibition of riba also means that it was replaced with risk-sharing scheme where the lender and the borrower share the profit or/and loss of an endeavour in an agreed formula. In other words, the existing financial products have to be innovated in such a way that, the relationship between the lender and the borrower has to be in the form of a partnership where risk is shared instead of being borne by a single entity. Unlike the conventional banking where the parties are seen as creditor and debtor and the creditor is rewarded for providing the fund. In Islamic financing, due to prohibition of riba, transactions are seen as partnering with mutual benefit.

The permissibility of risky capital investment without explicit interest earning has merged the thre basic form of Islamic financing into (1). synthetic loans which are debt-based through sales and repurchase agreements. (2). lease contracts based on assets through sales and leaseback agreements (operating lease) or third-party acquired assets with purchase obligations (finance lease). (3). profit sharing contracts which is equity based for future assets.[[14]](#footnote-13)

Generally, the design of these existing products such as savings account, current account, staff deposit account, credit card, lending, overdraft, house financing, personal financing, insurance are styled along various contract arrangements in Islamic finance. However the products, they are classified under the following arrangements:

* Ijarah: An arrangement where a bank leases an asset to a customer for a fixed period and at a fixed rate. At the time of maturity, the customer pays the value of the asset and the leased amount is deducted and the balance is returned to the customer.
* Mudharabah: When customers deposit money with a bank, the bank invests the money and shares profit from the investment with the depositors.
* Musharakah: an arrangement where a bank lends money to a borrower who then invest the money and share the profit and loss with the bank in an agreed ratio.
* Murabahah: This a contract which involves a bank purchasing goods identified by its client the purchase, then sells them to the client at an agreed mark-up. It is often repaid in installments.
* Wakalah: A contract of agency where the principal authorises another party to act his behalf.
* Qard: a contract of loan with no expectation of profit.
* Bai’Inah: a contract of sales by cash.
* Wadiah: Here, the bank guarantees a customer a total refund of his deposit with the bank when the depositor demands for it.
* Tawarruq: An arrangement where a customer buys an asset from a bank on deferred payment basis for the bank to sell to a third party on cash basis. The bank takes its share of the money and keep the remaining in the customer’s account.
* Istisna’ (Purchase Order): under this arrangement, the client manufactures goods for the bank while the bank provides the fund. The difference between the selling price of the goods and the cost price is the gain to be shared between the bank and the manufacturer.[[15]](#footnote-14)

Moreover, these contracts vary among financial institutions whether Islamic or non-Islamic institutions.

It was discovered that there are other products such as pawn broking, securities, money market instruments, bills, guarantees etc. which are allowed in some Islamic countries but not allowed in some. For instance, Pawn Broking “Al-Rahnu (a form of personal financing with gold as collateral) is allowed in Malaysia and Indonesia but it is prohibited in the Middle East and the North Africa.[[16]](#footnote-15) One keep fact stands in Islamic product design: there is no element of interest-taking for time value of money and it finances only transactions that have underlying assets. As Seibel et al opined, this is to avoid speculations which is against Shari’ah legislation and moral hazard and as such, only investors who have many years of business experience are financed. Investors with little or no business experience who are considered high-risk may receive a moderate amount of financing on ‘Qard Hasan’ term (an arrangement where profit is not expected of a borrower) free of any profit sharing margin but usually repaid by instalment though backed by collateral.[[17]](#footnote-16)

Each product can take any form of the contracts. For instance, a customer can open a saving or current account under Mudharabah, Wadi’ah or Qard hasan.

The prohibition has led to the growth of Islamic finance loan.[[18]](#footnote-17) The global footprint of the industry has become even larger and it has led to the development of some financial products which are quite doing well in the financial world. In 2019, the total assets of global Islamic banking amounted to about $1.99 trillion (US Dollars). It was projected to continue to increase.[[19]](#footnote-18)

On the other hand, Mushtaq S. et al, assess the effects of riba-prohibition on the financial decisions and on saving and investment using the random-effect and system generalised method of moments (GMM) model separately to data of 17 non-Islamic and 17 Islamic countries from 2005-2017, it was found out that people in Islamic countries are not concerned about interest rate on saving and as such other indices like remittances received and national expenditure have negative impacts on savings.[[20]](#footnote-19)

Also, many politicians see the idea of incorporating Shari’ah even if only technically, is a dangerous breach of secular principles. Some Islamic scholars fear that a more open attitude could also make it easier for radical Islamists to gain a foothold.[[21]](#footnote-20)

**BIBLIOGRAPHY**

Akhtar Md Uddi, Principle of Islamic Finance Prohibition of Riba, Gharar and Maysir (MPRA Paper No 67711, Nov, 2015).

All Answers Ltd :Literature Review on the Prohibition of Riba <ukduss.com April 2021>.

ARA Haqqi , The Philosophy of Islamic Law of Transactions (CERT Publication 2009).

Aris Abdul Nooraslinda et al, Islamic Banking Products: Regulations, Issues and Challenges (The Journal of Applied Business Research, Vol. 29, No. 4, July/August 2013) 1151.

Borhan J.T.B ; Sa’ari binti Che Zarrina, An Analysis of the Prohibition of Riba in the Qur’an.

CEO Zin Mohd AbdulRahim (New Straits Times, 14th January, 2002).

Chapra Umer Muhammad, Towards A Just Monetary System (1986).

Hayes Adam, Riba (2020) Investopedia <www.investopedia.com/terms/r/riba.asp> accessed 25 November, 2020.

Islamic Banking Processes and Products: Key Regional Variations (Oracle White Paper, September 2017).

Puri-Mirza Amna , Worldwide Growth of Islamic Bankind Assets, (January 29, 2021) <statista.com/statistics/1090891/worldwide-growth-of-islamic-banking-assets/>

Siddiqui S Mushtaq, Effect of Interest Rate on Economic Performance: Evidence from Islamic and Non-Islamic Economies. Finance Inno 29 (2016). <https: //doi.org/10.1186/s40854-016-0028-7>.

Siebel Dieter Hans; Imady Omar , Principles and Products of Islamic Finance (Working Paper No 1, Development Research Centre, University of Cologne, 2006)

The Economist: Islamic Finance in France Sharia Calling, a Political Row About Muslim Law (Nov. 12th 2009)

1. Haqqi ARA, The Philosophy of Islamic Law of Transactions (CERT Publication 2009) 123-124. [↑](#footnote-ref-0)
2. Adam Hayes, Riba (2020) Investopedia <www.investopedia.com/terms/r/riba.asp> accessed 25 November, 2020. [↑](#footnote-ref-1)
3. J.T.B Borhan; Che Zarrina binti Sa’ari, An Analysis of the Prohibition of Riba in the Qur’an 45. [↑](#footnote-ref-2)
4. Adam Hayes, Riba (2020) Investopedia <www.investopedia.com/terms/r/riba.asp> accessed 25 November, 2020. [↑](#footnote-ref-3)
5. Uddi, Md Akhtar, Principle of Islamic Finance Prohibition of Riba, Gharar and Maysir (MPRA Paper No 67711, Nov, 2015) 3 [↑](#footnote-ref-4)
6. All Answers Ltd :Literature Review on the Prohibition of Riba <ukduss.com April 2021> [↑](#footnote-ref-5)
7. Malik b. Anas, Al-Muwatts’, Kitab al-Buyu’, Bab al-Riba; J.T.B Borhan; Che Zarrina binti Sa’ari, An Analysis of the Prohibition of Riba in the Qur’an 50. [↑](#footnote-ref-6)
8. Muhammad Umer Chapra, Towards A Just Monetary System (1986) 63 [↑](#footnote-ref-7)
9. Al-Imam Al-Razi, Vol. 7, p. 87; J.T.B Borhan; Che Zarrina binti Sa’ari, An Analysis of the Prohibition of Riba in the Qur’an 51. [↑](#footnote-ref-8)
10. Muhammad Umer Chapra, Towards A Just Monetary System (1986) 57-58 [↑](#footnote-ref-9)
11. Khir et al, [2007]; Ahmad [2000] [↑](#footnote-ref-10)
12. Jurnal Usuluddin Bil 19[2004] 45-60 [↑](#footnote-ref-11)
13. Adam Hayes, Riba (2020) Investopedia <www.investopedia.com/terms/r/riba.asp> accessed 25 November, 2020. [↑](#footnote-ref-12)
14. Nooraslinda Abdul Aris et al, Islamic Banking Products: Regulations, Issues and Challenges (The Journal of Applied Business Research, Vol. 29, No. 4, July/August 2013) 1145 [↑](#footnote-ref-13)
15. Nooraslinda Abdul Aris et al, Islamic Banking Products: Regulations, Issues and Challenges (The Journal of Applied Business Research, Vol. 29, No. 4, July/August 2013) 1151 [↑](#footnote-ref-14)
16. Islamic Banking Processes and Products: Key Regional Variations (Oracle White Paper, September 2017) [↑](#footnote-ref-15)
17. Hans Dieter Siebel; Omar Imady, Principles and Products of Islamic Finance (Working Paper No 1, Development Research Centre, University of Cologne, 2006) [↑](#footnote-ref-16)
18. CEO Abdul Rahim Mohd Zin (New Straits Times, 14th January, 2002) [↑](#footnote-ref-17)
19. Amna Puri-Mirza, Worldwide Growth of Islamic Bankind Assets, (January 29, 2021) <statista.com/statistics/1090891/worldwide-growth-of-islamic-banking-assets/> [↑](#footnote-ref-18)
20. Mushtaq, S., Siddiqui, D.A. Effect of Interest Rate on Economic Performance: Evidence from Islamic and Non-Islamic Economies. Finance Inno 29 (2016). <https: //doi.org/10.1186/s40854-016-0028-7> [↑](#footnote-ref-19)
21. The Economist: Islamic Finance in France Sharia Calling, a Political Row About Muslim Law (Nov. 12th, 2009) [↑](#footnote-ref-20)