

OVERVIEW OF NON-INTEREST (ISLAMIC) FINANCE



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Overview of Shariah (Islamic Law)

Literal Meaning

The arabic word shariah (*شريعة*) refers in its literal meaning to the road to watering place, and signifies the way to God, as given by God.

It also means a straight path that must be followed.

Allah (S.W.T.) says: *لكل جعلنا منكم شرعة ومنهاجا*

To each among you, we have prescribed a law and a clear way. (5:48)

Technical Meaning

In Islamic context, *Shariah* refers to the laws and commandments and way of life prescribed by Allah to mankind.

Shariah refers to commands, prohibitions, guidance, and principles that God has addressed to mankind pertaining to their conduct in this world and salvation in the next.

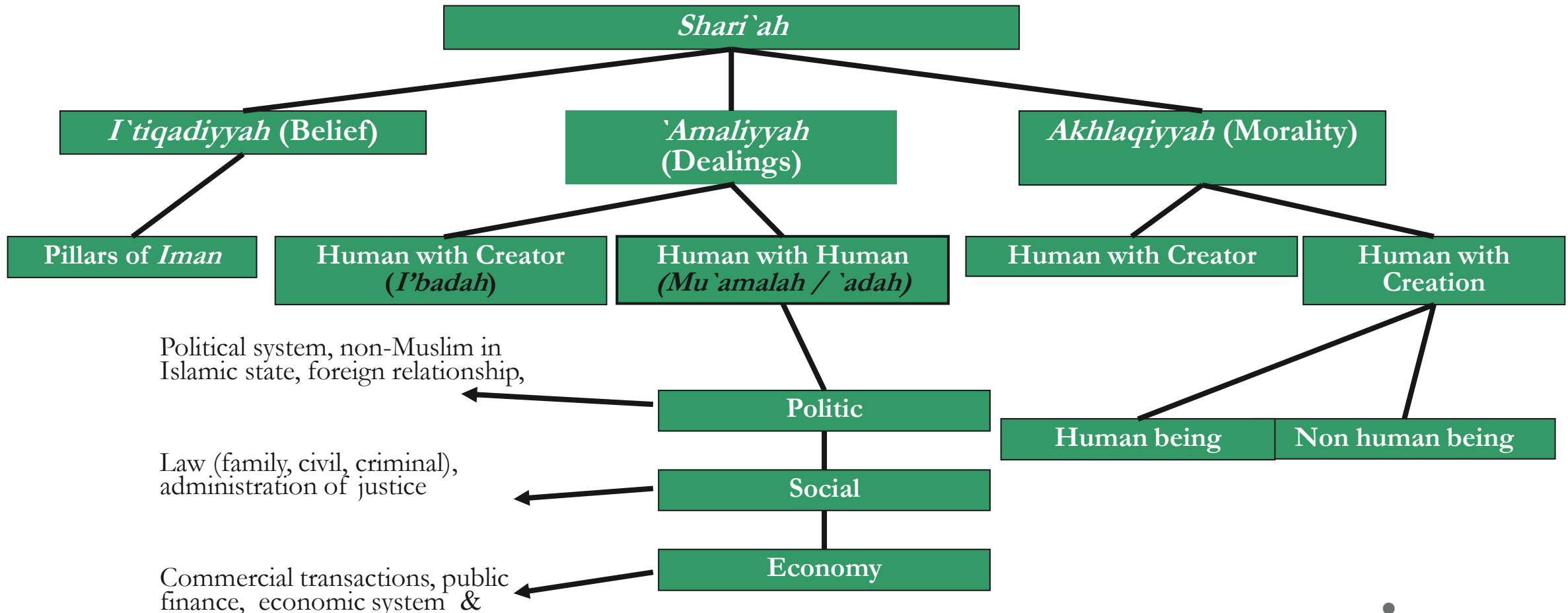
Shariah

- ❖ Abdul Karim Zaidan defined Shariah “as the path of religion and the various aspects of laws (al-ahkam) which Allah provides for his servants, i.e. human”.
- ❖ Shariah is the knowledge of the laws relating to human being’s acts and behavior, derived from specific sources, it is the commands of Islam in particular matters and application.
- ❖ Shariah is a code of life which consists from ideology, faith, behavior and obligation in the practical daily matters.
- ❖ In other words; shariah is the sum total of Islamic teaching and system, which was revealed to prophet Muhammad (s.a.w.) recorded in the Quran as well as deducible from the prophet’s guided lifestyle called Sunnah.

Islam, Shariah and Maqasid al- Shariah (Objectives of Shariah)

- ❖ Islam directs conducts of its adherents in all spheres of their lives, including:
 - Economic <https://quran.com/2>
 - Commercial
 - Legal
 - Social
 - Political
 - Personal, and
 - Public
- ❖ Lays down principles and scales for validating and measurement of activities: Permissible, mandatory etc are thus determined
- ❖ Objective of Islamic Law (Maqasid al-Shariah) is to:
 - protect the interest of mankind and prevent the evil from them,
 - realize the public benefit for the society,
 - encourage virtues and avoid vices.
- ❖ Therefore the Law is not an end in itself; it serves to attain an objective, a purpose which is the Maslahah (benefit).

Classification of Shariah



Sources of Shariah

Primary Sources:

1-Al-Quran (القرآن)

Literally, the word Quran is derived from Arabic root word, qara'a (قرأ) which means to read or to recite. Quran is a verbal noun and hence, it means the reading or recitation.

Technically, Quran has been defined as the speech of Allah, sent down upon the last Prophet Muhammad, through in its precise meaning and precise wording, transmitted to us by numerous persons (tawatur), both verbally and in writing which is inimitable and unique in its style, also being protected by God from any corruption.

إِنَّا نَحْنُ نَزَّلْنَا الذِّكْرَ وَإِنَّا لَهُ لَحَافِظُونَ

Indeed, it is We who sent down the Qur'an and indeed, We will be its guardian

Sources of Shariah

Primary Sources:

2- Sunnah (السنة)

Sunnah refers to anything from the prophet (S.A.W.) i.e. his acts, sayings, and tacit approval which are applicable to be used as evidences in legal jurisprudence.

3-Ijma' (الاجماع) consensus

Technically, it means the consensus of the mujtahids from the ummah of Prophet Muhammad (p.b.u.h.) after his demise in a certain period of time upon a practical legal ruling.

Ijma' plays a crucial role in the development of fiqh. Ijma' also ensures the correct interpretation of the Quran and Sunnah by consensus.

Once ijma' is established, it becomes a binding rule upon all the Muslims.

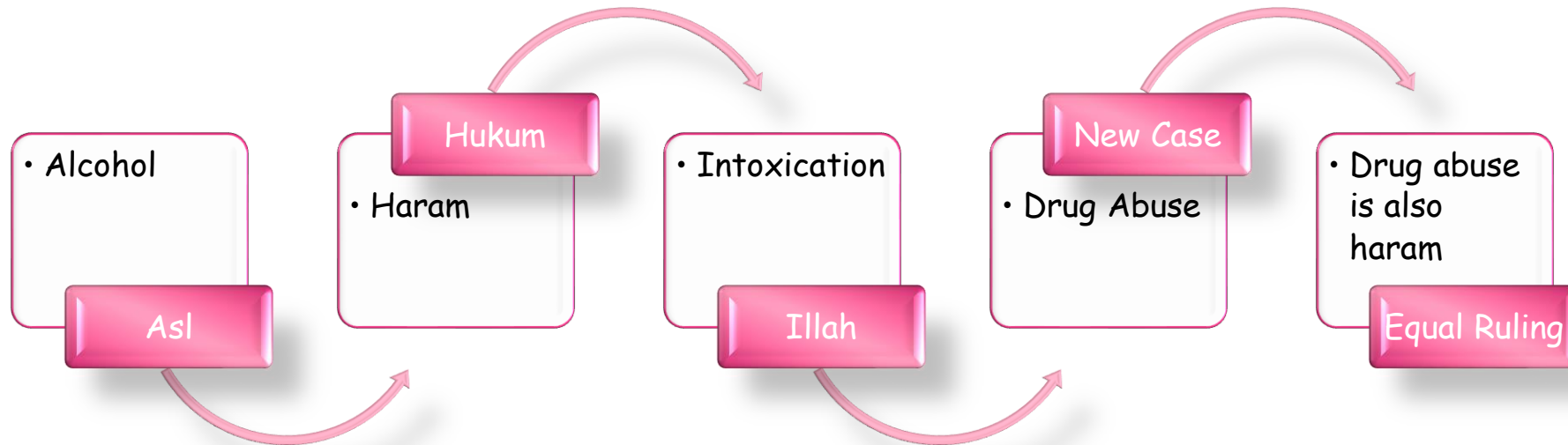
E.g. Ijma' on the prohibition of Human Cloning

Sources of Shariah

Primary Sources:

4- Qiyas (القياس) Analogy

Qiyas refers to the assignment of the ruling of an existing case found in the texts of the Quran, Sunnah or ijma' to a new case whose ruling is not found in these sources on the basis of a common underlying attribute called the 'illah of the hukm."



Sources of Shariah

Secondary Sources:

1-Istihsan (استحسان)

Istihsan is a legal principle which authorizes departure from an established precedent in favour of a different ruling for a reason stronger than the one which is obtained in that precedent.

E.g. requirement for a wudu' for prayer for a patient with bandage at wudu' part of body

2- Masalih Mursalah (مصالح مرسلّة)

Means consideration of Public Interest

There is no specific evidence for the ruling from quran, sunnah or ijma' but the ruling is needed for public interest

E.g. autopsy in criminal cases

Sources of Shariah

Secondary Sources:

3- Sadd Zaraei' (سد الذرائع)

Blocking the lawful means to an unlawful end, closing down the means of evil in order to prevent it. It signifies the prohibition of something which is originally permissible, because it could lead to an evil. E.g. to prevent the free selling of certain drugs as it could lead to abuse

4- Urf (عرف)

Customs or convention in accordance with the Shariah requirements. Urf as a source of Islamic law is not an independent proof on its right, but it can play a useful part in interpreting and implementing Islamic law.

5- Qawl Sahabi (قول الصحابي)

Views of the Prophet's companions. *Qawl Sahabi* is indeed important and deserves the highest consideration as they are the closest to the Prophet and have obtained direct knowledge from the Prophet, which means an opinion reached by the companions are by way of *ijtihad*.

Sources of Shariah

Secondary Sources:

6- *Istishab* (استصحاب)

is deemed good for something which has no evidence whether it is good or not. *Istishab* can be used in the absence of the proofs (*dalil*). It is not a strong ground for determining the rules of *Shariah*. Thus, when it conflicts with another proof (*dalil*), the latter takes priority.

OBJECTIVES OF SHARIAH (Maqasid al-shariah)

Objectives of Shariah (Maqasid al-shariah)

- ❖ Literal meaning of maqasid is objectives.
- ❖ The deeper meanings and inner aspects of wisdom (*hikam*) considered by the Lawgiver in all or most of the areas and circumstances of legislation.
- ❖ Shariah aims to govern human life to protect the interest of mankind and prevent evil by encouraging virtues and discouraging vices.
- ❖ Shariah also realizes public benefit for the society.

Objectives of Shariah (Maqasid al-shariah)

- ❖ Under the Shari'ah human affairs are divided into
 - The necessities or essentials (daruriyyat).
 - The needs (hajiyyat).
 - The complementary (tahsiniyyat).
- ❖ Ibn Ashur defined the daruriyyat as: “..things whose realization is essential for the community both collectively and individually, the social order of the community will not function properly if there is any defect in these things”.
- ❖ The Essentials (al-Daruriyyat) comprise the five fundamental and valuable matters in life, which are:
 - preservation and protection of religion (*al-din*),
 - preservation and protection of life (*al-nafs*),
 - preservation and protection of progeny or dignity (*al-'ird*),
 - preservation and protection of intellect (*al-aql*),
 - preservation and protection of wealth (*al-mal*).
- ❖ The conventional financial system focuses primarily on the economic and financial aspects of transactions, while the philosophical foundation of an Islamic financial system goes beyond that.
- ❖ Islamic Finance (Banking) is a subset of the Islamic Economic System, which includes: Takaful (Islamic Insurance), Zakat (Islamic Taxation), Waqf (Endowment), Capital Market

Objectives of Shariah (Maqasid al-shariah)

3 Levels of Interest

Dharuriyyat or Necessities

- necessary interest on which the life of man depends on and if they are violated the whole of human life would be threatened

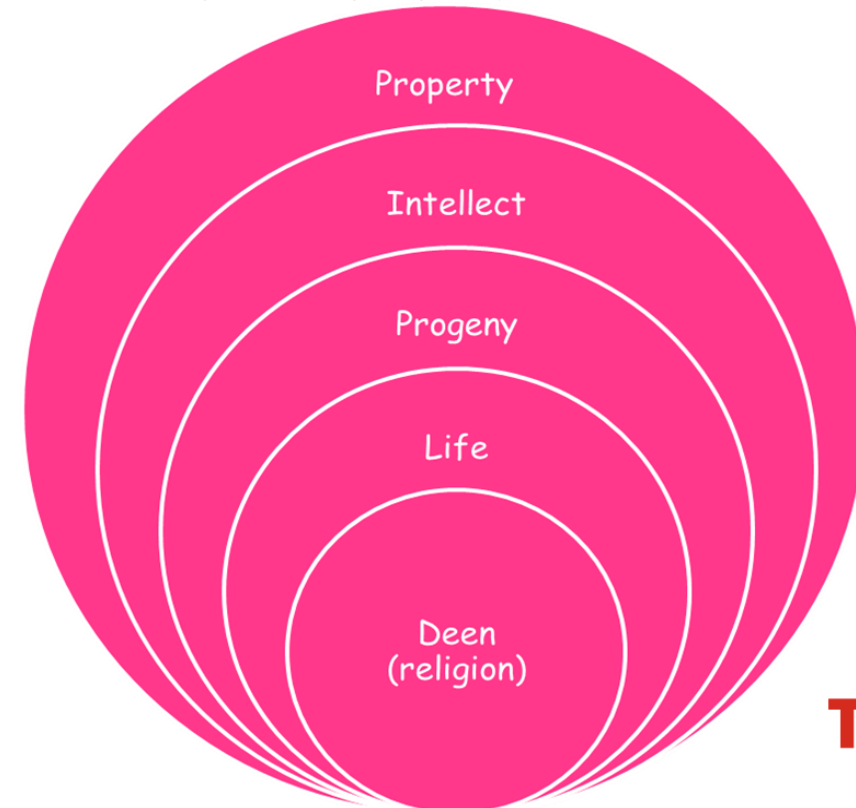
Hajiyyat or Supporting

- required by the necessary interest for their smooth operation and implementation

Tahsiniyyat or Complementary

- additional needs

By looking at the rulings of Shariah, the jurists deduced that the Shariah seeks to protect the 5 Necessities of human life: the religion, the life, the lineage, the intellect (aqal) and property.



Importance of Maqasid al-Shariah

- ❖ Texts are limited, but problems endlessly occur from time to time. Most times, there are no specific evidence directly addressing the emerging problem.
- ❖ By adherence to Maqasid, the rule of Shariah from the direct and specific text could be extended by using general principle regarding the purpose of laws.

E.g - The Case of Smoking

- ❖ Smoking is not mentioned in the Quran and Sunnah. It cannot be equated by way of Qiyas to alcohol because the rationale (*illah*) is not present in smoking (intoxication).
- ❖ But by understanding Maqasid, whereby protection of life is one of its basic purpose, smoking must be prohibited because it is against the protection of life.



Maqasid al-Shariah in Business Transactions

- ❖ The conventional financial system focuses primarily on the economic and financial aspects of transactions while the philosophical foundation of an Islamic financial system goes beyond that.
- ❖ According to the principles of maqasid al-shariah, the Islamic system places equal emphasis on the ethical, moral, social and religious dimensions to enhance equality and fairness for the good of society as a whole.
- ❖ This is reflected in the comprehensive code of maqasid al-shariah as comprehensive code for life. Accordingly Maqasid al-Shariah aims to achieve various objectives in business transaction, which are as follows:

Circulation of Wealth in Business Transactions

- The objectives of Shariah in business transactions is to make wealth available in the society and accessible to everyone who deserves it.
- It is very important from Maqasid al-Shariah perspective to ensure circulation of wealth in business transactions and avoid all forms of monopoly. This is clearly indicated in the Quranic verse:
“So that it may not be a benefit going round and round (dulah) among such of you as may already be rich” (59:7).

Maqasid al-Shariah in Business Transactions

Preservation and protection of the wealth in Islamic business transaction

- Preservation of the wealth in finance and business transaction is one of the primary objectives of Shariah as clearly stated in the Quran:

“O you who have attained faith, do not devour one another’s possessions wrongfully not even by way of trade based on mutual agreement, and do not destroy one another” (4:29).

- Another statement from prophet reads:

“No Muslim’s property should be allowed to be taken from him without his own accord”.

- These texts are very strong statement clearly indicating the importance and value of protection of wealth, whether for individuals or for the community and society.

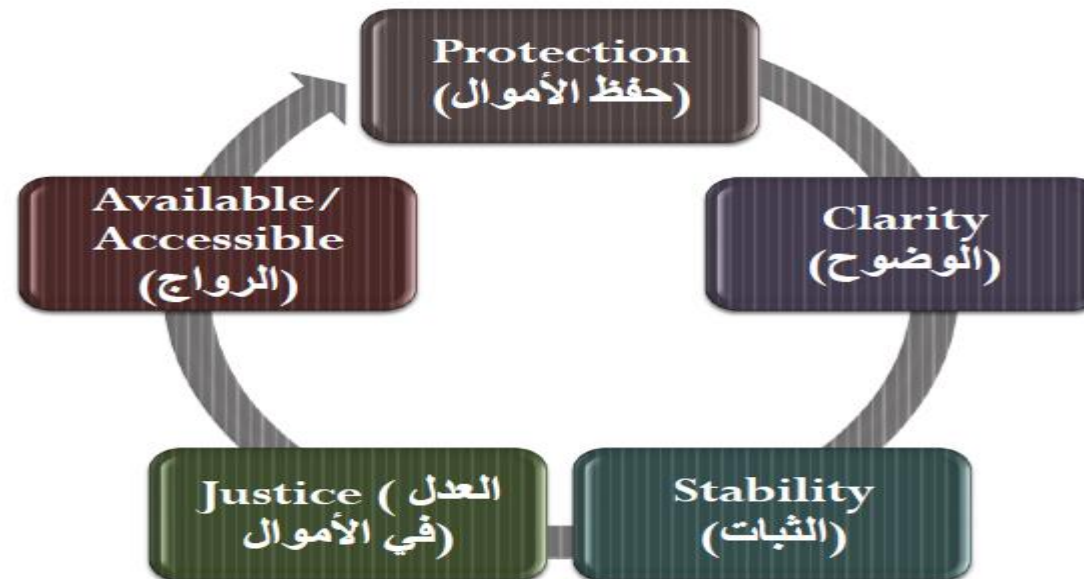
Right to Own and Earn

- The Shariah promotes the right to own, earn and create wealth through legitimate ways.

Maqasid al-Shariah in Business Transactions

Transparency in Business Dealings

- ❖ One of the very important elements of Maqasid Shariah is the avoidance of dispute among people in general as well as in the business community.
- ❖ Shariah emphasizes the need for transparency in business dealings as much as possible to prevent dispute.
- ❖ Transparency in the subject matter of business transactions entails providing adequate information to all relevant parties.



Islam, Shariah and Business Dealings

- ❖ Islam impress upon its adherents the fact that their existence is wholly for the service of Allah (Surah Zariyaat Q51 v. 56), including their daily commercial activities (Surah Juma' Q62 v. 9-10). In that light, Muslims are to eschew the following unethical practices:
 - Riba (Usury, interest) (details below)
 - Gharar (excessive risk, uncertainty or hazard that might lead to destruction or loss)
 - Unfair, unlawful and wrongful means of consuming people's wealth: Earning of income through unfair commercial practices like:
 - Ikrah: coercion, e.g. the imposition of a contract, or a condition therein, on an unwilling party.
 - Bay' al-mudtarr: exploitation of customers' or vendor's pressing needs and thereby charging an exorbitantly high price or offering extremely ridiculous price.

Islam, Shariah and Business Dealings

- ❖ Ihtikar: hoarding, withholding supplies of essential goods and services with a view to raising prices.
- ❖ Najsh: raising prices by manipulating false bids.
- ❖ Jahl mufdi ila al-niza': information asymmetry about a commodity, its quantity, price, etc., as may lead to dispute.
- ❖ Tatfeef: tampering with weights, measures and services (Q83)
- ❖ Monopoly
- ❖ Misrepresentation
- ❖ Sale of defective things or the things which are yet not in possession of the seller is strictly prohibited, except in few circumstances, i.e. Salam and Istisna.



ISLAMIC BANKING AND FINANCE

Regulatory Framework

- ❖ The Central Bank of Nigeria (CBN) pursuant to its powers under the relevant laws of the Federal Republic of Nigeria licenses and regulates Banks and Other Financial Institutions, which include Non-Interest Financial Institutions (NIFIs)
- ❖ NIFI means a bank or Other Financial Institution (OFI) under the purview of the CBN, which transacts banking business, engages in trading, investment and commercial activities as well as the provision of financial products and services in accordance with any established non-interest banking principles.
- ❖ Non-interest banking and finance models are broadly categorized into two:
 1. Non-interest banking and finance based on Islamic commercial jurisprudence;
 2. Non-interest banking and finance based on any other established non-interest principle.
- ❖ TAJBank Limited operates NIFI based on Islamic commercial jurisprudence

Fundamental Principles of Islamic Finance

- ❖ Usury is antagonized by all Abrahamic faiths (Judaism, Christianity and Islam).
- ❖ Riba: Usury (interest), usurious transactions, or activities that generates unearned income. Suratu Baqarah, Q2 v. 275 – 279. It is a way of preventing free circulation of wealth: “So that it may not be a benefit going round and round (dulah) among such of you as may already be rich” (Q 59 v. 7).
- ❖ In verse 279 Allah declared war against whoever will not give up whatever remains due to him from Usury
- ❖ Jabir reported the Noble Prophet (SAW) to have said:
لعن الله آكل الربا وموكله وكاتبه وشاهديه
- ❖ “Allah cursed the devourer of usury, its payer, its scribe, and its two witnesses. And he said that they are equal (in sin)”
- ❖ Exodus 22:24 (25)—If thou lend money to any of My people, even to the poor with thee, thou shalt not be to him as a creditor; neither shall ye lay upon him interest.
- ❖ Leviticus 25:36— Take thou no interest of him or increase; but fear thy God; that thy brother may live with thee



Fundamental Principles of Islamic Finance

- ❖ Riba AL-FADL is the excess over and above the loan paid in cash or kind. It lies in the payment of an addition by the debtor to the creditor in exchange of commodities of the same kind.
- ❖ Riba al-fadhl occurs when ribawi item is exchanged, not for equal amount, or equal but not exchanged on spot.
 - On this Abu Sayeed al-Khudri reported that the Messenger of Allah said: “Gold for gold, Silver for silver, wheat for wheat, barley for barley, date for date, salt for salt and like for like in hand to hand (transaction). Whoso gives more or takes more, then the taker and the giver are equal in taking interest therein.” (Sahih Muslim)
- ❖ Riba al-nasi'ah refers to the interest on loans; its prohibition essentially implies that the fixing in advance of a positive return on a loan as a reward for waiting, which is not permitted in Islam



Fundamental Principles of Islamic Finance

- ❖ The Shari'ah wishes to eliminate not merely the exploitation that is intrinsic in the institution of interest, but also that which is inherent in all forms of unjust exchange in business and commercial transactions
 - ❖ The rationale for prohibiting interest in the Islamic economic framework is to ensure that the risk-reward sharing would be more conducive to the realization of equity and the promotion of entrepreneurship
 - ❖ Islam prohibits the renting of money. Money has to become part of enterprise and combined with efforts to give profit. Investments results in profit or loss. Charging an extra amount on advanced sum, irrespective of the outcome of a commercial venture is
- injustice. Instead of renting money Islam recommends profit and loss sharing contracts among other humane contracts.
- ❖ Pre-determination of returns to the usurer ignores economic realities on the ground and therefore introduces distortion to the market



Fundamental Principles of Islamic Finance

- ❖ An Islamic economy is an **exchanged based** economy where value, goods and services are exchanged for money, contrary to a usury based economy, where principal economic activity is exchange of money for more money later.
- ❖ Islam wants society of investors and entrepreneurs; contrary to usury based economic system which creates a Society of lenders and borrowers.
- ❖ The unrestricted power of the creditor to make profit from interest has no regard to the financial ability of the debtor to repay indebtedness, middle-class consumers, as well as the developing countries, could be caught up in a never-ending debt-trap
- ❖ This leads some poorer countries to the over-exploitation of their earth's resources and thus to the destruction of the ecological system
- ❖ As such, poor countries are enslaved and crushed under debt to rich countries



Fundamental Principles of Islamic Finance



“All that we have borrowed up to 1985 or 1986 was around \$5 billion and we have paid about \$16 billion yet we are still being told that we owe about \$28 billion.

That \$28 billion came about because of the injustice in the foreign creditors’ interest rates. If you ask me what the worst thing in the world is, I will say it is compound interest”

President Obasanjo of Nigeria, G8 Summit in Okinawa, 2000

Fundamental Principles of Islamic Finance

- ❖ Gharar literally means uncertainty, ambiguity, danger or peril. Bai al-gharar is a sale contract which is attractive in form but ambiguous or unknown in substance
- ❖ Ambiguity in a sale contract leads to unknown results. The parties or one of them may not know what could be achieved from the contract which they have entered into.
- ❖ Quran states that Muslims should not 'devour one another's property wrongfully" (4:29) Sunnah of Prophet has specifically prohibited transactions which involve elements of gharar
- ❖ The main reason for the prohibition of gharar is that contracts involving gharar are fraudulent. Vagueness in contracts can be used to deceive people.



Fundamental Principles of Islamic Finance

- ❖ Ambiguities in contracts will arise when its pillars are not clearly defined.
- ❖ It is not confined to sale contract only, gharar may also exist in mudharabah, musharakah or kafalah when contracting parties are not known.
- ❖ It arises when delivery of sold item is uncertain, cannot be acquired, or not clearly defined.
- ❖ To prevent gharar, in a sale contract, the quality and quantity of subject matter, its price, date of payment, date of delivery must be agreed on by both parties. In Ijarah (Lease contracts) the usufruct and rental must be clearly defined.
- ❖ In Partnership contracts (Mudharabah), profit sharing ratio must be clear.
- ❖ However if the element of gharar is small and customarily accepted it is tolerated. E.g. Rental of hotel room without specifying how much water and electricity can be used

Fundamental Principles of Islamic Finance

Gharar vs. risk

- ❖ Risk refers to uncertainty an asset may earn a certain return or that a loss may occur. This type of uncertainty is not intentionally created by the parties nor designed to commit fraud.
- ❖ Parties make all efforts to minimise losses but they cannot totally eliminate loss and guarantee profit. Denying such risk goes against the maxim: "liability justifies returns"

Differences between gharar and risk

- ❖ Gharar is deceptive ambiguity while risk is uncertainty not designed to cheat.
- ❖ Gharar is not anticipated by innocent party; risk is anticipated
- ❖ Gharar is directed at counter party; risk is faced by all parties
- ❖ Gharar exist when information not fully disclosed; risk exists even when all information disclosed

Fundamental Principles of Islamic Finance

- ❖ Maysir literally means a way of easily obtaining something without any effort.
- ❖ It applies to all activities where a person wins or loses by mere chance.
- ❖ Includes all kinds of gambling. The Quran states:
"O ye who have attained to faith! Intoxicants, and games of chance, and idolatrous practices, and the divining of the future are but a loathsome Evil of Satan's doing: shun it, then, so that you might attain a happy state! By means of intoxicants and games of chance Satan seeks only to sow enmity and hatred among you, and to turn you away from remembrance of God and from prayer. Will you not then desist?" (Al Maidah, Q5 v.91)
- ❖ In gambling the winner and the loser wins or lose by pure chance, the winner does not lawfully earn what he has won and the loser loses his money without fair compensation.
- ❖ All contracts which involve elements of gambling are prohibited, because Islam encourages earning a living through honest effort and prohibits appropriating others property by chance.

Fundamental Principles of Islamic Finance

- ❖ Property which is subject matter of Islamic finance contract must be permissible. A contract involving a prohibited property is thus void.

- ❖ Contract involving liquor, intoxicants, pigs, blood, idols, and statues are not valid.

Prophet (PBUH) said “ When Allah prohibits a thing, he prohibits the price of it as well.”

- ❖ A Muslim cannot be a shareholder in a company that indulge in prohibited activities.

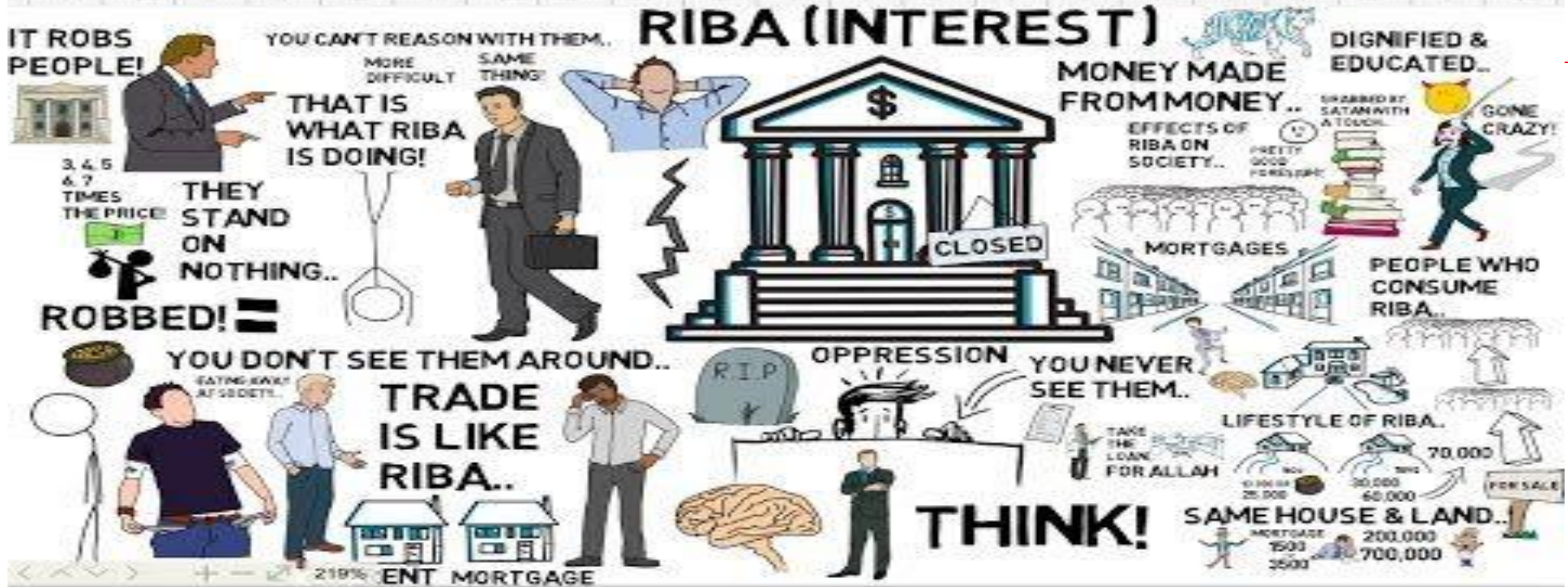
- ❖ If the primary activity of a company is based on riba', maysir, gharar and production and sale of haram

things then it is prohibited to buy and sell the shares of these companies

- ❖ It is thus not permissible for Muslims to buy and sell shares of conventional banks, companies that run casinos and gaming, companies that process, produce, market and sell alcoholic beverages, or supply non halal meat, or companies that provide immoral services

POSER

HOW DOES ISLAMIC BANKING DIFFER
FROM CONVENTIONAL BANKING?



Islamic Finance Vs. Conventional Finance

- ❖ A key difference between Islamic finance and conventional finance is the difference between buying and selling something real and borrowing and lending something fleeting.
- ❖ Islamic Finance is founded on trading mostly:
وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا
“ But Allah has permitted trade and has forbidden interest...” Baqarah Q2 v. 275
- ❖ Conventional banking transactions are interest based.
- ❖ Islamic bank transactions are asset or service backed.
- ❖ An asset or service cannot be compounded like an interest-based loan.
- ❖ An asset or service have buyer or seller at any given time, whereas interest allows cash to circulate and grow into enormous sums. Interest creates an artificial money supply that isn't backed by real assets resulting in increased inflation, heightened volatility, rich getting richer, and poor getting poorer.

Fundamental Principles of Islamic Finance

Islamic banking transactions must:

- ❖ Be interest free.
- ❖ Have risk sharing and/or asset and service backing:
Based on the Islamic concept of “no return without risk.” An Islamic bank takes a direct equity position, or buys a particular asset and charges a premium through a trade or a lease. It uses risk mitigants, but not without first taking ownership risk.
- ❖ Time value of money (commodity) is at the contracting stage, and no more
- ❖ Have contractual certainty: Contracts play a central role in Islam and the uncertainty of whether a contractual condition will be fulfilled or not is unacceptable in the Shariah.
- ❖ Be ethical: There is no buying, selling, or trading in anything that is impermissible according to the Shariah for instance dealing in conventional banking and insurance, alcohol, tobacco and any destructive item to humanity.

Islamic Finance Vs. Conventional Finance

Islamic Finance

The functions and operating modes are based on the principles of Shari'ah

Money is not a commodity, though it is used as a medium of exchange and store of value. Hence it cannot be sold or rented out at a value greater than its rental value.

Revolves around risk taking and risk sharing.

Promotes risk sharing between the provider of capital (investor) and user of funds (entrepreneur)

Conventional Finance

The functions and operating modes are based on man-made principles.

Money is a commodity, medium of exchange and store of value hence it can be sold at a price higher than its face value and it can also be rented out.

Concerned with the elimination and or total transfer of risk.

Investor is assured of predetermined rate of return with nil/negligible risk.

Islamic Finance Vs. Conventional Finance

Islamic Finance

Islamic Banks operate on the basis of profit and loss sharing

It creates a link with the real sectors of the economic system by using trade related activities

They are Gharar (uncertain/unknown) free transactions.

No provision to collect income from defaulters. Instead penalty is charged and given to charity to ensure equality between regularly paying and late paying customers.

Conventional Finance

Interest is charged/paid even when the borrower suffers losses.

It uses money as a commodity which leads to inflation and economic imbalance.

They involve speculative elements (Gharar).

It charges interest in the case of default which is considered as bank's income

Islamic Finance Vs. Conventional Finance

Islamic Finance

Discourages production of goods and services which are against the Islamic values (haram) such as gambling, alcohol etc.

The status of an Islamic bank in relation to its customers is that of partners, investors and trader, buyer and seller, as well as, lessor and lessee.

Conventional Finance

Cares less about goods and services which are harmful in general to the society and individual.
(The end justifies the means)

The status of a conventional bank, in relation to its clients, is that of creditors and debtors.

Islamic Finance Vs. Conventional Finance

Islamic Finance Contracts

Trade-Based Contracts

- Murabaha (Cost plus mark-up)
 - Bai Muajjal (Deferred sale)
 - Salam (Forward sale)
 - Istisna' (Manufacturing/Construction)
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Lease-Based Contracts

- Ijarah (Lease)

Fee-Based Contracts

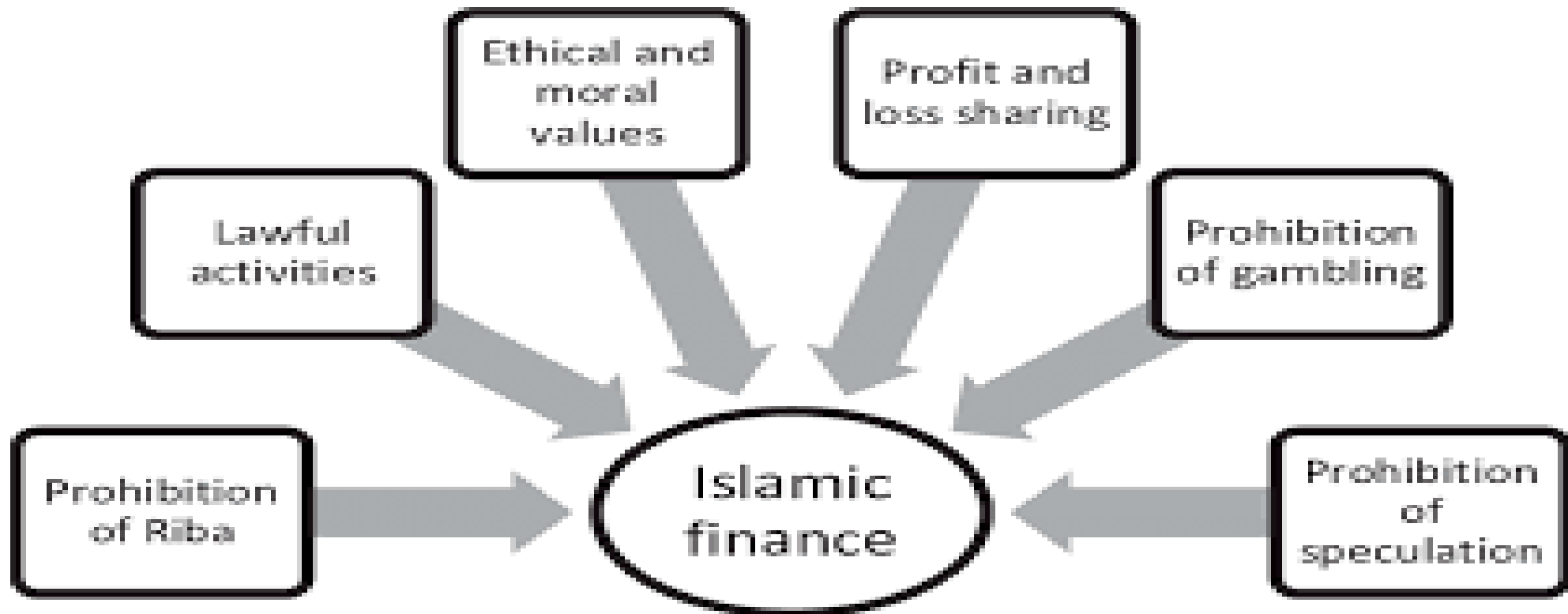
- Kafala (Guarantee)
 - Wakala (Agency)
-

Equity-Based Contracts

- Mudharabah (Profit sharing/loss bearing partnership)
- Musharakah (Profit and loss sharing partnership)

Conventional Finance Contracts = Majorly Interest-based Loan Contracts

Islamic Finance



THANK YOU!!!