

Islamic finance is based on the Abrahamic principles of fairness, justice and equality. Islamic finance promotes trade and forbids usury, interest and uncertainty. Compared to conventional finance, Islamic finance is more secure, more balanced and is open to all.

The Basic Difference between Capitalist and Islamic Economy

Islam does not deny the market forces and market economy. Even the profit motive is acceptable to a reasonable extent. Private ownership is not totally negated. Yet, the basic difference between capitalist and Islamic economy is that in secular capitalism, the profit motive or private ownership are given unbridled power to make economic decisions. Their liberty is not controlled by any divine injunctions. If there are some restrictions, they are imposed by human beings and are always subject to change through democratic legislation, which accepts no authority of any super-human power. This attitude has allowed a number of practices which cause imbalances in the society. Interest, gambling, speculative transactions tend to concentrate wealth in the hands of the few. Unhealthy human instincts are exploited to make money through immoral and injurious products. Unbridled profit making creates monopolies which paralyse the market forces or, at least, hinder their natural operation. Thus the capitalist economy which claims to be based on market forces, practically stops the natural process of supply and demand, because these forces can properly work only in an atmosphere of free competition, and not in monopolies. It is sometimes appreciated in a secular capitalist economy that a certain economic activity is not in the interest of the society, yet, it is allowed to be continued because it goes against the interest of some influential circles who dominate the legislature on the strength of their majority. Since every authority beyond the democratic rule is totally denied and 'trust in God' (which is affirmed at the face of every U.S. dollar) has been practically expelled from the socio-economic domain, no divine guidance is recognized to control the economic activities.

The evils emanating from this attitude can never be curbed unless humanity submits to the divine authority and obeys its commands by accepting them as absolute truth and super-human injunctions which should be followed in any case and at any price. This is exactly what Islam does. After recognizing private ownership, profit motive and market forces, Islam has put certain divine restrictions on the economic activities. These restrictions being imposed by Allah Almighty, Whose knowledge has no limits, cannot be removed by any human authority. The prohibition of *riba* (usury or interest), gambling, hoarding, dealing in unlawful goods or services, short sales and speculative transactions are some examples of these divine restrictions. All these prohibitions combined together have a cumulative effect of maintaining balance, distributive justice and equality of opportunities.

Asset-backed Financing

One of the most important characteristics of Islamic financing is that it is an asset-backed financing. The conventional / capitalist concept of financing is that the banks and financial institutions deal in money and monetary papers only. That is why they are forbidden, in most countries, from trading in goods and making inventories. Islam, on the other hand, does not recognize money as a subject-matter of trade, except in some special cases. Money has no intrinsic utility; it is only a medium of exchange; Each unit of money is 100% equal to another unit of the same denomination, therefore, there is no room for making profit through the exchange of these units inter se. Profit is generated when something having intrinsic utility is sold for money or when different currencies are exchanged, one

for another. The profit earned through dealing in money (of the same currency) or the papers representing them is interest, hence prohibited. Therefore, unlike conventional financial institutions, financing in Islam is always based on illiquid assets which creates real assets and inventories.

The real and ideal instruments of financing in Shari'ah are musharakah and mudarabah. When a financier contributes money on the basis of these two instruments it is bound to be converted into the assets having intrinsic utility. Profits are generated through the sale of these real assets.

Financing on the basis of salam and istisna' also creates real assets. The financier in the case of salam receives real goods and can make profit by selling them in the market. In the case of istisna, financing is effected through manufacturing some real assets, as a reward of which the financier earns profit.

Financial leases and murabahah, as will be seen later in the relevant chapters, are not originally modes of financing. But, in order to meet some needs they have been reshaped in a manner that they can be used as modes of financing, subject to certain conditions, in those sectors where musharakah, mudarabah, salam or istisna' are not workable for some reasons. The instruments of leasing and murabahah are sometimes criticized on the ground that their net result is often the same as the net result of an interest-based borrowing. This criticism is justified to some extent, and that is why the Shari'ah supervisory Boards are unanimous on the point that they are not ideal modes of financing and they should be used only in cases of need with full observation of the conditions prescribed by Shari'ah. Despite all this, the instruments of leasing and murabahah, too, are fully backed by assets and financing through these instruments is clearly distinguishable from the interest-based financing on the following grounds.

1. In conventional financing, the financier gives money to his client as an interest-bearing loan, after which he has no concern as to how the money is used by the client. In the case of murabahah, on the contrary, no money is advanced by the financier. Instead, the financier himself purchases the commodity required by the client. Since this transaction cannot be completed unless the client assures the financier that he wishes to purchase a commodity, therefore, murabahah is not possible at all, unless the financier creates inventory. In this manner, financing is always backed by assets.

2. In the conventional financing system, loans may be advanced for any profitable purpose. A gambling casino can borrow money from a bank to develop its gambling business. A pornographic magazine or a company making nude films are as good customers of a conventional bank as a house-builder. Thus, conventional financing is not bound by any divine or religious restrictions. But the Islamic banks and financial institutions cannot remain indifferent about the nature of the activity for which the facility is required. They cannot effect murabahah for any purpose which is either prohibited in Shari'ah or is harmful to the moral health of the society.

3. It is one of the basic requirements for the validity of murabahah that the commodity is purchased by the financier which means that he assumes the risk of the commodity before selling it to the customer. The profit claimed by the financier is the reward of the risk he assumes. No such risk is assumed in an interest-based loan.

4. In an interest bearing loan, the amount to be repaid by the borrower keeps on

increasing with the passage of time. In murabahah, on the other hand, a selling price once agreed becomes and remains fixed. As a result, even if the purchaser (client of the Bank) does not pay on time, the seller (Bank) cannot ask for a higher price, due to delay in settlement of dues. This is because in Shari'ah, there is no concept of time value of money.

5. In leasing too, financing is offered through providing an asset having usufruct. The risk of the leased property is assumed by the lessor / financier throughout the lease period in the sense that if the leased asset is totally destroyed without any misuse or negligence on the part of the lessee, it is the financier/lessor who will suffer the loss.

It is evident from the above discussion that every financing in an Islamic system creates real assets. This is true even in the case of murabahah and leasing, despite the fact that they are not believed to be ideal modes of financing and are often criticized for their being close to the interest-based financing in their net results. It is known, on the other hand, that interest-based financing does not necessarily create real assets, therefore, the supply of money through the loans advanced by the financial institutions does not normally match with the real goods and services produced in the society, because the loans create artificial money through which the amount of money supply is increased, and sometimes multiplied without creating real assets in the same quantity. This gap between the supply of money and production of real assets creates or fuels inflation. Since financing in an Islamic system is backed by assets, it is always matched with corresponding goods and services.

Capital and Entrepreneur

According to the capitalist theory, capital and entrepreneur are two separate factors of production. The former gets interest while the latter is entitled to profit. Interest is a fixed return for providing capital, while profit can be earned only when there is a surplus after distributing the fixed return to land, labour and capital (in the form of rent, wages and interest).

Islam, on the contrary, does not recognize capital and entrepreneur as two separate factors of production. Every person who contributes capital (in the form of money) to a commercial enterprise assumes the risk of loss and therefore is entitled to a proportionate share in the actual profit. In this manner 'capital' has an intrinsic element of 'entrepreneurship', so far as the risk of the business is concerned. Therefore, instead of a fixed return as interest, it derives profit. The more the profit of the business, the higher the return on capital. In this way the profits generated by the commercial activities in the society are equitably distributed to all those persons who have contributed capital to the enterprise, however little it may be. Since in the context of the modern practice, it is the banks and financial institutions who provide capital to the commercial activities, out of the deposits made with them, the flow of the actual profits earned by the society may be directed towards the depositors in equitable proportions which may distribute wealth in a wider circle and may hamper concentration of wealth in the hands of the few.

(Excerpt from *An Introduction to Islamic Finance* by Mufti Muhammad Taqi Usmani)