

An Introduction to Modern Islamic Economics and Finance

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ABSTRACT

This paper attempts to examine Islamic economics from the standpoint of conventional economics. Included is a background of the canonical prohibitions that are the foundations of Islamic banking and finance. The precise meaning of the terms *ribā* and *gharār* are also explored. Given that today's complex financial markets did not exist during the classical age of Islam, the adoption of a more objective-driven approach and the pursuit of disciplined freedom from the mindset of outmoded texts are also addressed.

I. INTRODUCTION

Many of the assertions made in the name of "Islamic economics and finance" do not make much economic sense to a "mainstream economist." Taking off my Islamic economist hat and putting on my regular economist hat, I shall try in this brief talk to make some sense of the assertions of Islamic economists. I am primarily concerned in this talk with what I believe Islamic banking and finance is truly about. Therefore, for the duration of this talk, I shall ask you to forget what others say about it. We have talked about Islamic economics elsewhere, and tried to understand it from an insider's point of view. In what follows, I shall try to give you a standard economist's informed and sympathetic point of view.

I always like to refer to Judge Richard Posner's statement: "Often the true grounds of legal decision are concealed rather than illuminated by the characteristic rhetoric of opinions. Indeed, legal education consists primarily of learning to dig beneath the rhetorical surface to find those grounds, many of which may turn out to have an economic character." He is talking about American common law, but I think this is much truer of Islamic law. Islamic jurists often justify their juristic rulings on the basis of *Ḍaqq* (justice): that clearly this or that is what justice dictates, without providing a thorough account of the analysis on the basis of which they reached that conclusion. So you have to dig more deeply, as Judge Posner does in opining that legal education basically consists in training to drill beneath the rhetoric in order to find the true basis of decisions. This is my task as an economist and an Islamic economist: to venture into books of jurisprudence, trying to understand the implicit analysis underlying professed opinions. In many cases, the type of analysis that jurists professed to be doing was *different* from what they actually did.

II. THE PROHIBITIONS OF *RIBĀ* AND *GĦARĀR*: WHY DO THEY EXIST?

Talk about Islamic banking and finance is often dominated by discussions of business ethics. The truth of the matter, however, is that this industry would not be here if the prohibitions of *ribā* and *gharār* had not driven people away from conventional banking, through fear of transgressing against the Sacred Law, thus forcing them to think of other alternatives. Ethical aspects are all very good, and we try to include them in the analysis whenever we can, but basically the industry is driven by prohibitions. When someone stands in the mosque and says, "*Ribā* is *Ḍarām* and you're declaring a war against Allah and His apostle," that's what will bring ordinary people to start thinking about Islamic banking and finance.

When talking about prohibitions, we must mention why those prohibitions are there, because basically all the financial instruments available today were not available when the original legal documents were drawn up. And they definitely did not exist when the canonical documents, the Qur'an and Sunna, were revealed. Hence jurists have to make inferences from the canonical texts and later explanations by jurists. To do this, they have to go back and determine what objectives of the law were served by various prohibitions, to see whether we can extend the prohibition of *ribā* and transfer it to something like modern-day interest (in all its forms). When we address the objectives of the law as they pertain to financial innovations that were not dealt with in the original texts, analysts have to rely on reasoning by analogy, thus giving rise to many differences in opinion.

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In this regard, one must wonder why certain prohibitions were spelled out explicitly in canonical texts, while others were not. For instance, there is no explicit text prohibiting hitting one's head against the wall a hundred times each morning, but it's obvious to us that that's harmful. By contrast, explicit prohibitions will be required in cases where there is a subtle benefit to abstaining from the forbidden activity, but casual empiricism would not reveal that benefit. In economics jargon, that says that optimal social behavior may not be "incentive-compatible." For example, if I think of what is best for me right now, I may not see that I should not engage in *ribā*. However, if I think about it more deeply, I might recognize that abstention from the forbidden *ribā* would make everyone in society better off. However, it might be the case that given the behavior of all others, each member of society has a myopic, individual incentive to defect. This is a basic tension between issues of economic efficiency (what is best for society), and equilibrium behavior (where no one can do any better by deviating from the social norm). Immanuel Kant expressed this notion in moral philosophy using the "universalization of behavior" hypothesis. For instance, it is best for society if nobody lies, thus enhancing the level of trust, and minimizing monitoring costs. However, given that everyone else tells the truth, I can gain an advantage by lying. But then if I universalize this behavior and consider a society in which everybody lies, then all confidence in the supposed society deteriorates, and the foundation of society would collapse. In the economic sphere, there are many instances of conflict between individual advantage given the actions of all others, and social benefit. In such instances, a religious prohibition can make everyone better off by providing a disincentive for each individual against deviating from the efficient social norm. In essence, the prohibition alters the individual preferences to put them in line with the social preferences. Paradoxically, the end-result is an improvement of social welfare, including for all the individuals who would otherwise have caused the social norm to collapse.

III. HOW DO WE DEFINE "RIBĀ" AND "GHARĀR"?

According to Ibn Taymiyyah, almost all prohibitions of economic transactions can be reduced to one of two things: *ribā* or *gharār*. We have to grapple with what *ribā* is from an economist's point of view, avoiding the many bad translations and ideological misconceptions surrounding it. The first thing you read or hear on Islamic finance is that "interest is forbidden in Islam." However, the most basic analysis of the behavior of Islamic banks will show that this is a gross oversimplification. An extreme form of *ribā*, certainly, is *lending* with interest. There's no question about this: if I lend you a dollar with a condition that I must collect two dollars at a later date, this is a form of forbidden *ribā*. However, there are many forms of modern "interest" that jurists have allowed, whether or not they wish to use the word "interest." For instance, the markup over cash prices in credit-sale and lease financing contracts, upon which 95% or more of Islamic banking is based, lend themselves trivially to the calculation of the interest rate in this contract. Refusing to use the term "interest" for this markup does not change its nature, and only helps to confuse the issue. In my research (c.f. my paper on the prohibition of *ribā* in the Proceedings of the Third Harvard University Forum on Islamic Finance), I have arrived at a definition of *ribā* as "the sale of credit."

The second prohibition mentioned by Ibn Taymiyyah is of *gharār*, which most people confuse with some of its instances, such as gambling, deception, etc. In another paper of mine (c.f. proceedings of the Islamic Development Bank's 4th International Conference on Islamic Economics), I have found, after reviewing the opinions of jurists and through economic analysis, that the best definition of *gharār* is "trading in risk." The extreme form of *gharār* is gambling, where you pay a certain amount of money to have a roulette wheel, say, spun, and you win money if the ball falls in a particular slot.

Thus, I have argued that the two major prohibitions underlying the need for Islamic finance are prohibitions of trading in credit and trading in risk. This is an important problem, since any interesting financial transaction involves the transfer of credit and/or the transfer of risk. The questions are, how do you regulate such transfers of credit and risk, and how do the contemporary Islamic alternatives that have evolved based on contemporary jurisprudence make sense from an economic point of view?

IV. MISCONCEPTIONS SURROUNDING RIBĀ

Starting with *ribā*, it is noteworthy that modern translations of the Qur'an, and English books on Islamic jurisprudence, translate *ribā* either as "interest" or as "usury." Both are bad and misleading translations. In fact, *ribā* is a term that does not have a good single-word translation in English (unless one uses the literal meaning of the term, i.e., "increase," but then it loses all juristic meaning). It is surprising that Arabic terms such as *murābaʿa*, *bayʿ bi-thaman aʿjil*, *ijāra*, and so on, are very common in Islamic banking, despite the fact that good translations of those terms are readily available (e.g., cost-plus sale, credit sale, and leasing, respectively). In contrast, the use of

the English terms “interest” or “usury” (and even the Arabic word for interest, *fa’ida*) has all but replaced the use of the technical term *ribā*, for which no English translation is available.

Ribā and interest are not the same thing: there is *ribā* without interest, and there is interest without *ribā*. The famous *@adīth*, “Gold for gold, silver for silver, salt for salt, dates for dates, barley for barley, and wheat for wheat, hand-to-hand, in equal amounts; and any increase is *ribā*,” clearly states two conditions: hand-to-hand and in equal amounts. Thus, trading those goods for others of the same genus in different amounts is still *ribā* [*al-fa’al*], even though there is no time factor and therefore no interest. Thus, there is therefore *ribā* without interest. On the other hand, all jurists agree in credit sales that a time value can be attached, so if a cup would sell for a dollar as cash-and-carry, I can sell it for \$1.20 if I’m being paid in one year. Any child can divide the \$0.20 mark-up by the \$1.00 cash price and calculate an annual interest rate of 20%. However, this is not forbidden *ribā* because the interest is embedded in the credit price of a valid sale. Nonetheless, it is interest without forbidden *ribā*. Hence, we have shown that neither does all forbidden *ribā* involve interest, nor does all interest involve forbidden *ribā*.

Another common misconception is that the prohibition of *ribā* is meant primarily to prevent exploitation of poor debtors. In this regard, the popular translation of Yusuf Ali is misleading, because he stops in the middle of the verse on *ribā*, adding a separate sentence: “If you repent, then you shall keep your capital sums. Deal you not unjustly, and you shall not be dealt with unjustly.” In fact, the commentary of all major exegetes (Ṭabarī, Qurṣubī, etc.) suggests that the verse continues in a single sentence: “But if you repent then you can keep your principals without inflicting or receiving injustice,” which they explained as “without any increase or diminution.” The exploitation explanation is quite old. Al-Subki, in his continuation of Al-Nawawī’s *Al-majmū’*, reported an opinion by Ibn Kayyisān that *ribā* was prohibited in order to prevent rich creditors from exploiting poor debtors. However, that explanation was fully debunked because it is easy to exploit individuals through loans with exorbitant interest that are denominated in non-*ribāwī* goods [*ribāwī* goods, based on the six mentioned in the *@adīth*, are limited to fungible goods that are measured by volume or weight, or monetary numeraires].

According to Merriam-Webster’s dictionary, one of the definitions of “interest” is “the profit in goods or money that is made on invested capital.” If I invest capital in a commodity and aim to make a profit through a credit sale, the return is called interest. Hence, the translation of forbidden “*ribā*” as interest is incorrect. Moreover, the translation of forbidden “*ribā*” as usury is also mistaken, since modern usage of the term refers only to exorbitant interest. However, interest in a loan is forbidden *ribā*, regardless of its percentage. Hence, the use of “usury” is also incorrect.

A further prevalent fallacy is that *ribā* is “return without risk.” However, the risk in a loan with interest is identical to the risk in a credit sale: credit risk. If \$1.00 is used in a loan that is to be repaid as \$1.20 in one year, or to buy a \$1.00 commodity that is sold with a credit price of \$1.20 payable in one year, the risk and return are the same. In both cases, once the debt is established on the borrower or buyer, the risk borne for one year is the possibility that the debtor cannot pay the \$1.20. The differences between the two contracts are subtle: the credit sale involves automatic collateralization of the debt, and the rate of return can be easily marked to market using the rental value of the property (again, see my paper on the prohibition of *ribā* for further details and a complete analysis).

Thus, I would argue that the forbidden *ribā* is not the same as interest, is not the same as usury, is not only about exploitation, and is not about return without risk. Some also say that there is no time value of money in Islam. Populist arguments abound that if you put money in a jar it does not multiply, etc. In fact, the concept that money is sterile is a Catholic doctrine alien to Islam. There is a time value of money as long as it is used in a real transaction. Shaykh Yusuf al-Qaradawī, in his book on *zakāt*, notes that “*zakāt*” means “increase” or “growth,” and therefore concludes that all properties with the property of growth or “*namā*” (including money) are subject to *zakāt*. *Ribā* also means “increase,” so *ribā* and *zakāt* linguistically are almost synonyms.

V. AN ECONOMIC EXPLANATION FOR THE PROHIBITION OF *RIBĀ*

The question then is: Interest alone is forbidden as *ribā*, but interest in a credit sale is not—why? Humans are known to exhibit dynamic inconsistency. In the paper I referred to earlier, one can go through verses of the Qur’an that mention that people are dynamically inconsistent in their thinking about future vs. immediate returns. Through experimental evidence and theoretical work, we know that people are inconsistent in the sense that if there is a restaurant that offers a good steak and a good salad, I might go there with the intention of eating the salad. Once I see the menu before me, however, I end up eating the steak. The solution to this in economic theory is that I go to a restaurant that does not offer steak. So even though the restaurant that offers steak might be offering better salad, I

go to the other restaurant so that I will not be worried about my future self not following through with my current plan. This is called pre-commitment.

In fact, this pre-commitment explanation underlying the prohibition of *ribā* can be deduced from a *@adīth* in which Bilal (may Allah be pleased with him), went to the Prophet (peace be upon him) with dates that he really liked. The Prophet asked where he had gotten them, and Bilal replied that he had traded lower-quality dates for the higher-quality ones. The Prophet (peace be upon him) was very angry: he said that this was precisely the forbidden *ribā*. Instead, he (peace be upon him) said that Bilal should have sold the low-quality ones and used the money to buy the others. This practice forces pre-commitment, because you first find the person who will buy your original product from you at the highest possible price, and then the person who will sell your desired product to you at the lowest possible price. This “marking to market” ensures that the ratio at which the low-quality dates are finally traded for the high-quality dates corresponds to the ratio of their market prices. This is a pre-commitment mechanism explanation of the prohibition of *ribā al-faʿool* (which does not involve interest). I extend the analysis to dynamic settings in which interest is inherent, showing that the prohibition of *ribā al-nasāʾ* also imposes pre-commitment to tie the time value of money in a real transaction to the time value of the real object of that transaction (through marking its rental value to market).

VI. MANIFESTATIONS OF *GHARĀR*

Now we turn to the forbidden *bayʿ al-gharār*. What is it? Under the section on *gharār* in a book of jurisprudence, a long list of Prophetic traditions indicates instances of forbidden transactions. Some involve ambiguity in contract language: two sales in one is described by Imam Al-Shāfiʿī as a practice in which a person says, “You can buy this for \$1 now, or \$1.20 in a year, and whichever you accept becomes binding on me.” Thus, the offer is ambiguous, resulting in a prohibition based on uncertainty that may lead to dispute. There are other examples of prohibitions based on unnecessary uncertainty, such as the sale of a diver’s catch. That’s another Prophetic tradition: you cannot pay a diver an amount of money and say that whatever he catches is yours. However, you can lease his diving services for an hour. In a hiring contract, one can define either the work or the time, thus knowing what one is paying for. By contrast, one cannot pay for the future catch because there is unnecessary uncertainty, but I can pay for one hour of the catcher’s time, and there is no uncertainty about the latter. Another set of instances of *bayʿ al-gharār* involves undeliverable merchandise. Thus it is forbidden to sell birds in the sky and fish in the sea, for instance. Another forbidden instance is that of selling an unborn calf, in which case the object of sale might never materialize if the calf is stillborn. It is difficult to find the economic principle that is common to all those examples.

When the contract language contains ambiguity, it is easily possible to avoid *gharār* by eliminating the ambiguity. In this regard, most ambiguity can be removed by using known contracts in books of Islamic jurisprudence. The detailed rulings for each contract in each school of Islamic jurisprudence serve as the proverbial “fine print” for those contracts, eliminating all unnecessary ambiguity. Thus, if someone offers you a “lease” and you know that he follows Ṣanafī rulings, then you go to whatever is accepted in the Ṣanafī school and read the fine print, since any later disputes will be decided accordingly. Thus ambiguity in contract language can be eliminated.

However, *gharār* also involves uncertainty in most cases. The best definition of *gharār*, in my opinion, is that given by the late Professor Mustafa Al-Zarqa: *bayʿ al-gharār* is “the probable sale of items whose existence or characteristics are not certain.” Al-Zarqa then says that that renders the sale similar to gambling. A major Mālikī jurist, Al-Bajī Al-ʿAndalusī, said that the Prophet (peace be upon him) in the Prophetic tradition does not say that *gharār* itself is *@arām*, only that the sale of *gharār* is forbidden. As a matter of fact, a majority of jurists (with the exception of the Shāfiʿīs) permits uncertainty in a gift contract. Thus, Al-Bajī said that what the Prophet (peace be upon him) meant by *bayʿ al-gharār*, or the sale of *gharār*, is a sale in which *gharār* is a major component. Thus, the reason jurists disagree over whether to forbid a certain transaction is that they differ on whether *gharār* is present as a major or a minor component.

In juristic terms, the prohibition only applies to commutative financial contracts in which property changes hands, e.g. in sales. In my recent paper on the prohibition of *gharār*, presented at the IDB 4th International Conference on Islamic Economics (c.f. <http://www.ruf.rice.edu/~elgamal/files/gharar.pdf>), I provided an economic explanation of this prohibition based on a human idiosyncrasy called loss-aversion. To give a simple example, consider the recent computer purchase I made at a store. After I selected the computer and was in the process of paying its \$1200 price, the salesperson asked whether I would like to buy the store’s “Extended Warranty Plan.” I thought for a second and asked how much it cost; he replied \$200. He said, “You know, this screen alone, if it breaks down, will cost you \$700 to replace.” I thought, “He is appealing to my fear of potential loss—he could have

told me earlier that I could either get it for \$1200 with a limited warranty, or get it with the extended plan for \$1400” (ignoring for a second the issue of two sales in one). However, he probably knew that at the buying stage, I would compare the inherent insurance in the \$1400 package to the lower price of the \$1200 package, and probably would not have taken the extended warranty plan. But, he waited until I felt that the computer was mine. At that time, I feared losses more than I would have before I actually bought it, and I may buy the forbidden insurance for \$200. Thus, Islamic jurisprudence would have allowed permissible risk sharing by bundling the insurance with the purchase (the extended warranty package for \$1400), but forbids the sale of risk through insurance (the post hoc insurance for \$200). In sharing the risk, the risk transfer is just a small component of the computer package with which it is bundled, and thus does not qualify as the sale of risk.

VII. *RIBĀ* AND *GĦARĀR* IN STANDARDIZED CONTRACTS

Thus, we may gain an appreciation of the economics of the prohibitions of *ribā* and *gharār*. But when we read books of Islamic jurisprudence, we encounter numerous standardized named contracts—standardized in the sense that each school of jurists developed extensive rules on what constitutes a valid or invalid *murābaʿa* with *bayʿ bi-thaman aʿjil*, *ijāra*, etc. These are alternatives in which credit is extended without selling credit directly, so they do not involve forbidden *ribā* even when they clearly involve interest. In credit sales, a fourth-grader can calculate the implicit interest rate from the cash price and the marked-up credit price. In a lease, the same fourth-grader can similarly calculate the interest rate. But *ribā* is absent because the major component is the sale of the good or the service. Thus, the named contracts avoid the sale of credit by bundling it in real economic transactions.

Similar provisions in standardized named contracts are made to ensure that risks are shared rather than sold. For instance, in silent partnerships (*muʿāraba*), the provider of the capital risks losing his capital, while the worker risks losing his labor if the partnership produces no profits. But if the venture turns a profit, the investor and the worker share the realized profits according to the rules agreed upon beforehand. In *mushāraka*, or simple partnership, profits are shared according to an agreed-upon formula and losses according to the initial capital contribution. Thus, various partnership contracts specify how risks are shared between the partners. This eliminates unnecessary ambiguity and the potential for disputes, and ensures that the main objective of the contract is to engage in productive and profitable activity rather than merely to reallocate risks among parties.

There are exceptions to the prohibitions of *ribā* and/or *gharār* that jurists explicitly permit based on the Sunna or juristic approbation (*istiʿsān*). For instance, in *salam* contracts, which are the Islamic alternatives to forward contracts, the buyer pays a price instantly for goods to be delivered in the future. In many cases, this contract is used when the object does not exist. This is a classical form of *gharār*—the very object does not exist at the time of the contract. Moreover, it may often involve *ribā* based on the difference between the forward and the spot market prices. The contract is permitted, however, based on the *ʿadīth* that whoever engages in a *salam* contract, let him specify the term of the contract, the price to be paid, and the characteristics of the item. *Istisnāʾ* (commission to manufacture) is a similar contract permitted based on juristic approbation. In that contract, the price is paid in installments as the object of the contract is being manufactured. Thus, we have standardized contracts that either evade *ribā* or *gharār*, or limit them to the absolutely necessary extent. Jurists worked over the centuries to perfect all the details (or “fine print”) of those standardized contracts within their respective schools of jurisprudence.

Before sophisticated legal mechanisms were available for writing lengthy contracts, this standardization served an important role in facilitating business dealings. Thus, individuals could simply shake hands and agree to engage in an *ijāra*, *salam*, *istisnāʾ*, etc., and everyone would understand what they meant. Moreover, if a dispute should ensue, they would have to accept arbitration based on the rulings of that contract in the appropriate school of jurisprudence. Today, we have the facilities to write down the specific details of a lease or credit sale contract, and we do not need the implicit fine print of the books of jurisprudence anymore. Why then do people use Arabic terms? One reason is that jurists feel confident when they know that they are basing their decisions on solid precedent. Instead of innovating, they can say that they know *murābaʿa* is correct, so if they use the same word and make minimal changes to what the term meant in a twelfth-century text, they feel that they are on solid ground.

Contemporary jurists and bankers can also gain credibility by appealing to the authority of certain historically renowned scholars, thus claiming that their current decisions are derived from the views of such highly respected historical figures. Perhaps one can push this cynical line of thinking further, and argue that the use of the Arabic names of contracts gives the jurists an unfair advantage by forcing others to argue on their turf. All professions try to gain an advantage over outsiders by creating a jargon in which they have a comparative advantage, and jurists are not exception to this trend. This ability to exclude others and form a closed circle of “scholars”

allows members of the circle to collect rents that they would not otherwise. Indeed, the lucrative business of serving on so-called *sharī'a* boards of Islamic banks is a good proof of the existence of such rents.

However, there are also practical considerations that encourage the use of those Arabic terms. The fine print of any contract requires continuous refinement. By using the Arabic term, one has something that is ready-made, and then all that one has to do is add small changes as the need arises. You take, for example, a *murāba'ah* contract and add to it that it is *murāba'ah li-al-amr bi-al-shirā'* (cost-plus sale on order), as many Islamic banks did in the 1980s. In the original cost-plus-credit sale, the person who already owns the car sells it to you at a higher credit price than the cash price he paid for it. But then the jurists respond, "What if you do not own the car and the person wants to buy it from a dealership? Can he tell you to go buy it from a dealership and sell it to him at a higher price and make the promise that he will buy it?" If one can take the existing credit sale, and add this small innovation to it, while preserving the name of the classical contract, the innovation seems less revolutionary.

Thus, we have seen the positive advantages of using the standardized contracts of classical Islamic jurisprudence, with their Arabic names. However, legal machinery that allows us to transcend that jargon is now in place, and well-trained lawyers can do a better job defining the fine print than a medieval jurist, regardless of the sophistication of the latter by the standards of his time. Whether the conclusions from the classical fine print that lawyers produce will abide by the canonical texts is an issue that we have to discuss. But do we have to be constrained by that fine print and merely be adding to it? The end result of this process often is an unnecessarily long and soon-to-be obsolete contract. The main question is this: are we serving the objectives of the law in the best way we can by adjusting the classical fine print of contracts, or are we better off starting from scratch? We often hear calls nowadays to transcend the old texts of classical jurisprudence, quoting Ibn Taymiyya's maxim that "the default in transactions is permissibility." Thus, all we have to do is to ensure that any proposed new contract does not transgress the law by inclusion of a forbidden factor such as *ribā* or *gharār*. However, the problem with such a pro-active approach is one of credibility. It is easy for jurists to return the debate to their turf by questioning the person's credentials and ability to infer that a new contract is devoid of forbidden factors. Indeed, some of the most respected contemporary jurists were severely criticized by other jurists for venturing in this direction.

VIII. CONCLUSION

Thus, Islamic finance is likely to remain trapped for the foreseeable future between the small juristic perturbations of classical contracts, and the faulty rhetoric of "prohibition of interest" and "no time value of money." I hope that the sophisticated listener/reader will be able to see beyond those shortcomings. In particular, I hope that he or she can recognize that there are valid substantive advantages that an Islamically inspired financial sector may have over its conventional counterpart. This is an invitation to others who, like myself, may come to the areas of Islamic economics and finance after acquiring some degree of expertise in mainstream economics and finance: Do not be discouraged by the faulty rhetoric and the archaic understanding of financial affairs. When the novelty of Islamic finance as a fad expires, the rents to be collected from scared Muslims run dry, and the rhetoric of ideologues and scaremongers fizzles away, we may yet have a reasonable economic and financial vision to be called "Islamic."

