# Chinks in the capitalism system – the pertinence of Islamic finance

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**Abstract:**

Buying and selling occurs when a seller provides an item to a buyer at a price agreed by both parties. On the other hand, riba (usury or interest) is when someone gives a certain capital to another person with a condition that it is to be returned with a certain gain. Interest (usury), considered a taboo in Islam, has been one of the major causes of the financial crises in the West with the recent ones being the American subprime crisis and European sovereign debt crisis. What used to be the superpowers of modern finance have turned into indigent states. This paper compares both conventional and Islamic finance and looks at how Islamic finance can avoid the same mistakes from happening again. Islamic finance combines the divine and the secular with emphasis on spiritual values and social justice. In contrast to the western's 'Maximizing shareholders' worth' concept in finance, Islam states that profits in business must be accompanied with responsibility. It puts emphasis on profit sharing in lending funds. If one is not taking any business risks, he/she has no right to its profits. In a conventional banking system, due to the interest being charged, resources cannot be fully utilized as the funds available are discounted by interest fee. As such, usury is just not acceptable in Islam and would be destructive in any economic system.

Keywords: Usury, Islamic Banking, Conventional Banking, *Riba*, Interest, *Zakat*

## INTRODUCTION

In the third quarter of 2011, the Japan's main stock index Nikkei 225 lost 3.4% to 9,329.75. South Korea's stock market shed 4.2%, while Australia's declined 2.4%. In Europe, the UK's FTSE witnessed £160.9billion ($261billion) being wiped off its market value. In Germany, the Dax has lost 85.5 billion euros, while France's Cac lost 13.6 billion euros. All these occurred as a result of a huge sell off in the Wall Street due to the jitters from the European sovereign debt crisis. The US Dow Jones index closed down 512.76 points, or 4.3%, at 11,383.68; its worst day since 2008. This pattern of uncertainty has been persistent in the financial market since the early 20th century. According to Stiglitz (2010), more than 100 financial related crises have occurred for the past 30 years. Since the financial market has always been a zero sum game, many would have been hit hard. Uncertainty in the financial world leads to panic related activities such as mass selloff and bank runs. Unfortunately, uncertainty has become a constant in a capitalist economic equation due its nature, in which, market forces dictate most of the equilibrium points for economic variables (e.g. supply, demand, price, interest rates, and foreign exchange rates). While relying on market forces would seem befitting, ignoring whether the interactions between the supply and demand of the market forces are real or artificial (speculative) can be damaging to an economy.

Karl Marx, the 19th Century German philosopher, economist and revolutionary, believes that capitalism is radically unstable. He believes that capitalism has a built-in tendency to produce ever larger booms and busts, and over the longer term it is bound to destroy itself (Gray, J. 2011). Companies and industries are created and destroyed in a continuous stream of innovation, while human relationships are taken aback and reinvented in new forms. Capitalism can been described as a process of creative destruction, in which, anything that it touches is influenced in a significant manner. For example, when capitalism embraces the paper industry, it almost wipes off the rain forest from the face of the earth. When capitalism embraces the automobile industry, it covers the world with smog and pollution.

In capitalism, it seems that the persons who borrow heavily and aren't afraid of bankruptcy (*i.e.* over leverage) are the ones who survive and prosper. Sheng (2011) outlines the weaknesses of the present finance sector, that lead to the financial crisis, into three major areas; 1) over-consumption, 2) over-leverage, and 3) bad governance. Instead of exercising discipline over its borrowers and investors, banks do not even exercise discipline over its own leverage and risks. The finance sector encourages its customers and itself to take on more leverage in the search for yield. During the US financial crisis, mortgage sellers even collateralized their debt with a combination of both prime and subprime debt for the sake of profit.

While capitalism and communism represent two opposite extremes, Islam takes to the middle path by recognizing the individual rights as well as the public rights (*Maslaha*). The objective of this paper is to make comparisons between conventional and Islamic finance theory and practice. This paper highlights the Achilles' heel of the present western capitalism system, which is interest (*riba*) based, and suggests the views from the Islamic finance perspective in overcoming the problems posed by the present form of capitalism.

### Background

Islamic finance emphasizes the wellbeing of public (*maslahah*), whereas conventional finance emphasizes individual utility (Al-Qaradhawi, 2009). According to Walsh (2007), Islamic finance prohibits five major elements, 1) interest (*riba*), 2) uncertainty (*gharar*), 3) gambling (*maisir*), 4) non-halal products, and 5) immoral activities. It makes no separation between the spiritual and the material and puts great emphasis on values and social justice. Social justice is attained by safeguarding not only the faith, life, mental, lineage but also wealth. To safeguard wealth, Islamic finance emphasizes on the true ownership of assets, the process to accumulate wealth and the uses of wealth. The process of wealth accumulation should be free from any form of oppression, especially, usury (*riba*).

Usury or *riba* is a form of oppression since the rich becomes richer and the poor becomes poorer. Muhammad (1996) suggests that in the practice of usury (*riba*), the lender, while retaining full ownership of the capital loaned, and having no legal concern with the purpose for which it is to be used or with the manner of its use, remains contractually assured of gain irrespective of any losses with which the borrower may suffer in consequence of this transaction. Thus, the condemnation of usury (*riba*) is undisputable due to the fact that it is closely connected with the socioeconomic motivation underlying the relationship of borrower and lender. Islam puts emphasis on the question as to how profits and risks may be equitably shared by both partners of a loan transaction. If one is not taking any risk, he or she is not entitled to any gains from the endeavor. On the other hand, conventional finance is based on the maximization of individual utility, welfare, and choice (Matthews & Tlemsani, 2010).

Through the revealed knowledge, God has commanded and taught human beings to ensure peace, justice and prosperity on earth by maximizing the utilization of all resources based on the "abundance mentality" perspective. God says in the al-Quran; "*Verily Allah is full of Bounty to mankind but most of them are ungrateful*" (*Yunus* 10:60). Unfortunately, the world began to regress slowly towards resource scantiness, greed and brutality as a consequence of intellectual bankruptcy in the form of "scarcity mentality". Classical economists have defined scarcity to be the fundamental problem in an economy where humans who, supposedly, possess unlimited wants and needs are faced with a world of limited resources. A misguided search for knowledge due to weak philosophical foundations, has led the researchers and scholars to emulate the nature and life of lower beings as a metaphor and basis for guiding human affairs. Thus, the damaging concepts such as 'limited resources', 'winner takes all', 'survival of the fittest' *etc.* become the new guiding principles for human actions and interactions (Ismail, 2011). Illustration of the concept of resources in conventional and Islamic economy is shown in figures 1 and 2, respectively (Appendix).

In figure 1, the scarcity mentality shows the factors of economy (e.g. government, household, business and organization) competing for resources that are limited. Factors in the economy need to make choices between different resources that are available because the resources are limited. This could lead to hoardings, greediness and possible violence in contending for the limited resources. On the other hand, in figure 2, the abundance mentality (Ismail, 2011) works on the belief that resources that are available (even though limited) are there to be shared by all factors of economy with the concept of sharing and caring of society. This would lead to a much desirable world that encourages the process of innovation and creativity among people. Famine, monopolistic competition, scrupulous act and war would be less likely to occur in such settings. This is the intention of Islamic teachings; to provide the balance in all human lives in this earth.

Another important concept in the Islamic economy is *zakat* or religious levy. The purpose of *zakat* is to "purify" the surplus wealth of the relatively well-to-do by redistributing it to the destitute and needy (Siddiqi, 1982). It is one of the five pillars of Islam, that is, giving out a fixed

portion of one's wealth to the beneficiaries of *zakat* called *asnaf* ( e.g. the poor, the needy, the reverts etc). *Zakat* is the privilege of the poor and vital in optimizing economic well being and human welfare. Islam imposes *zakat* as a religious levy from the assets owned by rich people to be allocated to the poor masses. However, the assets need to attain the minimum threshold quantity required (*nisab)* and be in possession for one year (*haul*) before it can be considered for *zakat* (Kahf, 2005). *Zakat* is calculated as 2.5% of the net current assets (including gold, silver and currency) after deducting the current liabilities from the rich people and is the prerogative of the poor (Rab, 2006). God has stated in the Quran,
”*That which Allah giveth …, that it become not a commodity between the rich among you.”* (*Al-Hashr* 59:7).

### What is usury or *riba*?

Literally, the term usury (*riba*) denotes an ‘addition to’, or an ‘increase’ of a thing over and above its original size or amount (Maududi 1970). In the terminology of the Holy book Al-Quran, it signifies any unlawful addition, by way of interest, to a sum of money or goods lent by one person or body of persons to another. Specifically, there are two types of *riba*, namely 1) *Riba An Nasiah* and 2) *Riba Al Fadl*. *Riba An Nasiah* occurs when time is allowed for the borrower to repay the loan after its due date. In return, the borrower must pay the additional or premium for the extension in duration, *i.e.* interest on lent money or capital. *Riba* or interest is gained without any effort from the loan provider to the debtor. The loan giver is actually taking the advantage from the debtor (Hosein 2001). *Riba Al Fadl* occurs as a result of trade or sale transactions. Taking a superior thing of the same kind of goods by giving more of the same kind of goods of inferior quality, e.g., apples of better quality for apples of inferior quality in greater amount.

One should clearly understand the difference between what is called as profit and what is usury or *riba*. Allah has allowed the businessmen to gain profits from trading, but clearly prohibits both *riba* arising from trade as in *riba al fadl* or from the loan transaction i.e. *riba an nasiah.*
This is justified in the Quran, “…but Allah has permitted trade and forbidden *riba*” [*Al Baqarah*: 275].
Profit is achieved when the total revenue from business activities exceed the total cost of the business activities. Profit is allowable in Islam because it arises from the business/trading activities where there is a physical sale transaction. Thus, usury, or *riba*, or interest, cannot be considered as profit.

### Islamic finance and the Western economy

The pinnacle of all these financial mires is the US financial crisis where greed has led to the almost collapse of the entire world’s financial system. Over eager bankers would provide financial tools to those who did not deserve. This led to the bankruptcy of Lehman Brothers and other banks in US would have followed suit if it was not for the US government’s intervention. The blame cannot be shouldered by the bankers solely as they have targets to meet in order to meet their goals at the end of the year. The capitalism’s ‘Maximizing shareholder’s value’ ideology plays a huge role here. This is what that is being taught in most modern finance related text books. According to Brigham and Houston (2007),

'… *management's primary goal is stockholder wealth maximization, which translates into maximizing the price of the Firm's common stock'*.

The shareholders' wealth is measured by taking the present value of cash flows discounted at the opportunity cost of the capital (Copeland and Weston 1992). The discounted cash flows consist of the stream of possible future dividends and capital gains. Thus, as long as one is making positive cash flows, he or she is considered appropriate and desirable regardless of how the cash flows come about.

The opportunity cost's (interest) movement is explained via many theories. Studies by Kessel (1965) and Hicks (1946) suggest the Liquidity Premium theory, in which, a change in interest rates will have a greater effect on the price in the long term compared to the short term. This adds an element of higher risk for the longer term financial instrument, which, in turn demands a higher interest rate. There are many other theories explaining the movements of interest rates such as the Market Segmentation Hypothesis (Walker (1954), Culbertson (1957), and Mogdiliani and Sutch (1966)) and Unbiased Expectation Hypothesis (Fisher, 1896 and Lutz, 1940). The prophet Muhammad (peace be upon him), has mentioned:

"*Narrated by Abu Huraira r.a.: A time will come upon the people when one will not care how one gains one's money, legally or illegally."* (Khan 1996).

Islam takes a different view on maximizing one's profit. Maximizing profit in Islam must come together with responsibility (Hasan & Ahmad 2005). This includes responsibilities towards God and fellow human beings. Instead of maximization of profit, Islam encourages making 'sufficient' profit (Siddiqi 1979). This is the middle path between maximum profit and charity; high enough profit to make the business attractive but still within religion constraints and not too low such that it is enough to cater one's lifestyle and not contribute towards business losses.

The USA has just been stripped of its AAA credit rating by credit rating agency Standard & Poor's from AAA to AA+ (Blackden 2011). This will have a great implication on the US economy as interest rates will fly all over. At the same time, European debt crisis is getting worse, with Italy and Spain coming under scrutiny after Greece and Ireland. This is unlikely to occur in an Islamic Financial system where interest (usury) is prohibited. Risks are shared among the lenders and borrowers. If business was not good, borrowers would pay less to the lenders (or not pay at all). But when the economy swings upwards, the borrowers will pay more to share its profit with the lenders. According to Ahmed (2010), there are four likely major causes of the present financial crisis from the Islamic finance point of view. They are 1) creating money from money, 2) selling debts, 3) short selling, and, 4) absence of risk-sharing. Matthews and Tlemsani (2010) outlined the differences between Islamic and conventional finance as indicated in Table 1 (Appendix)) which demonstrates glaring weaknesses of the latter which led to numerous financial crises such as, the European debt crisis and US banking crisis. Table 1 shows a comparison between Conventional and Islamic Finance, and this indicate that financial crisis can be avoided if Islamic finance concepts were used and adopted in business and all related transactions.

One of the main objectives of Islam is to realize greater justice in human society. To understand why Islam prohibits *riba*, we have to look at the differing views between capitalism and Islam on money and commodity. Hassan (2007) states that, capitalism, makes no difference between money and commodity in commercial transactions. On the other hand, Islamic principles differ from capitalism in this concept and make it clear that money and commodity have different characteristics. Firstly, money does not possess intrinsic value but it is only a measure of value or a medium of exchange. It cannot physically fulfill human needs by itself, but has to be exchanged into a commodity. On the other hand, a commodity can fulfill human needs directly by itself. As such, selling a USD100 note for USD110 would be the same as selling a bag of wheat costing USD100 for USD110 in capitalism. In Islam, however, selling a USD100 note for USD110 would make no sense since the money in itself has no intrinsic utility. Secondly, unlike money, commodities can differ in quality. A brand new USD100 note is exactly equal in value and quality to an older USD100 note but a brand new car will be much better than an older car. Thirdly, commodities transactions are done by physically identifying the item of interest or at least by providing certain specifications of the commodity that are of interest. It would be pointless to do so for money since different denominations of money making up an equal amount would have the same ultimate value. Therefore, when money is exchanged for money, any excess amount charged against deferred payment is *riba*, since the excess is charged only against time. Table 2 (Appendix) below summarizes the difference between money and commodity.

## WHY IS USURY DAMAGING FOR AN ECONOMY

"…in terms of who is paying whom, data from the Congressional Budget Office shows that the U.S. pays out some 74 million dollars to China in interest payments on debt every day... That means Washington is paying Beijing 833 dollars every second." (Zakaria, 2011).

Islamic Finance system does not allow the creation of debt through direct lending and borrowing. It only allows the creation of debt through the sale or lease of real assets via sales- and lease-based modes of financing such as *murabaha*, *ijara*, and *sukuk* (Ahmed, 2010). Maududi (1970) provides a rebuttal on conventional logic that argues for interest (usury):

1. Western economists claim that the party that gives out the loans is putting its asset at risk, incurring opportunity costs, and putting other people's interest over theirs. As such, it is their right to impose a rent on this risk taking effort. But the question is, does the loan giver have the right to make it a constant source of income (daily, monthly, yearly *etc*.) on this risk of his asset for other people's interest? It would suffice for the loan giver to be guaranteed an asset (collateral) that will be used to guarantee his loan. Putting other people's interest over ones' is very noble but to make a source of income from it is not. Loan givers cannot charge interest as they have not incurred any opportunity cost as the loan comes from the access of his/her funds. If there was any other avenue for him/her to invest he/she would do so and not lend the money to others. It is unfair for the loan givers to set a guaranteed profit margin, a priori, while the loan takers take the huge portion of risk without knowing what his/her profit margin is going to be.
2. Interest is the price of money. There is a time component of money (as in the time value of money) that is being taught in all finance textbooks. The argument here is, what price has the lender paid to the borrower that gives him/her the right to a guaranteed income? There is no guarantee that the borrower will make profits at the end of his endeavors. The lender didn't lift a finger in the borrower's business undertaking and has no right to set his profit margin before anything else.
3. The third argument for usury is that to exact a fee in profit, as a price for capital (that is being used), is normal. This is because the capital that is being used will attract profit, naturally. If someone used another person's capital for productive activities, the owner of the capital would automatically have a right on a fee for his capital. This is because, if not for the capital, the activities would not have been possible in the first place. Again, if one's not taking any business risks, he/she has no right to its profits.

4. Most modern finance textbooks emphasizes that money now is better than money in the future (for example, Gitman & Madura (2004) and Ross *et. al.* (2004)). What that is certain today is better compared to something that is uncertain in the future. As an example (Francis 1991), for bond transactions, the Liquidity Premium Theory asserts that;

" *…the yields from long-term bonds should be a little higher than the yields of a short term bonds. This theory maintains that investors pay a price premium on shorter maturities to avoid the higher interest rate risk prevalent in the longer maturities. Thus, an upward sloping yield curve is considered normal."*.

In other words, the longer the financial instrument is, the more uncertainty it has and higher interest rates should be charged. If money today is better than money tomorrow, why do we have savings? Is $100 today worth less than one year ago? While inflationary pressures do contribute to the depreciation of currencies, it is not perpetual. Deflationary pressures have the opposite effect. The value of a currency can be less, same, or even more than a year ago. For example, the Chinese Yuan today is much stronger than it was ten years ago.

In another study, according to Rab (2006), Islam prohibits interest because:

- it leads to the exploitation of the poor
- it makes it difficult for an economy to fully utilize its full productive capacity, and
- it leads to major economic imbalance that lead to massive inefficiency and waste.

**Conventional vs. Islamic Banking System**

Prior to Fiat money, people transacted with gold. Gold is being kept in banks with a paper as proof of deposit. This piece of paper is then used in transactions as whoever owns it could redeem the gold from the bank. As time goes by, the paper replaces gold. Rarely would anyone redeem the gold back from bank. Bankers realize that depositors do not usually withdraw all their savings at once. Banks take this opportunity to lend out this excess money in return for interest, as if they are the real owners of the money (not the depositors). In fact, most of the capital in the bank comes from the depositors and not the bank owners. The peculiar thing is, while the depositors contribute the most to the bank's capital, they do not have any rights to interfere in the banks' operation. The banks' management and shareholders make the decisions.

With tremendous developments in ICT technology, financial engineering and financial innovation, the finance sector has morphed from a service agent to a self-serving principal that is much larger than the real sector itself. The total size of financial assets (stock market capitalization, debt market, and bank assets - excluding derivatives) has grown from 108% of global GDP in 1980 to over 400% by 2009 (Sheng 2011). The financial sector has become significantly larger than the real sector in the world economy. How is it possible that for a sector that is not producing something tangible, making more money than the real sector? While the people in the real sector toiled, and took the risk, to maintain profitability, the bankers pushed papers and make money via usury (with almost zero risk). This is totally unfair and one sided. Global financial institutions have outgrown the ability of both their host nations and the global regulatory structure to underwrite and supervise them. During the 2007 crisis, western countries have resorted to bailing out the financial sector from its own mistakes. This has contributed to larger fiscal deficits for those countries. However, it has to be said here that regulators have, since, come out with tougher regulations such as the Basel 3 tier 1 capital levels to ensure that banks hold more high-quality capital to protect against potential losses

The European sovereign debt crisis has forced the European Central Bank (ECB) to rescue countries such as Greece, Ireland, Spain, and Italy. Fearing that a country will default on its debt, investors will only provide loans only for a much higher interest rate for the reason of higher risk associated with sovereign debts. Countries that need to roll over its debts worry that they will have to accept new loans at a much higher interest rates. This will definitely put pressure on their economy. Krugman (2011) proposes that ECB intervene and purchase some of these sovereign bonds. He also suggests that the ECB lend to these financially troubled countries freely or at a very low interest rate, which is in line with Islamic values.

Mannan (1986) provides a model that shows the impact of interest free banking and conventional banking in figure 3 and 4(Appendix). In an Islamic banking system, due to the absence of interest being charged, businesses can fully utilize all the resources available. This in turn, will lead to a fully functional economy which would lead to more income and savings. Furthermore, with the implementation of *zakat*, the less well to do will get a share of the economy and this will lead to a much more equitable society. In a conventional banking system, due to interest that is being charged, resources cannot be fully utilized due to the less funds available (which has been discounted by interest). This creates an economic condition that has a high chance of depression with less income and savings. With the absence of the *zakat* system, the not-well-to-do will not be able to taste a slice of the economy. This might lead to social injustice.

**The difference between buying/selling and *riba***

It is clearly stated in the Quran, "…*Allah permitteth trading and forbiddenth usury*…" (*al-Baqarah* 2:275). This verse emphasizes that trading such as buying and selling activities are allowable in Islam and usury or *riba* is forbidden.

Buying and selling occurs when a seller provides an item to a buyer after an agreement between them on its price. The buyer possesses the item after pays the seller a certain amount of money. The item is either made or bought by the seller. The profit is for the seller's hard work in making or sourcing the item. On the other hand, *riba* is when someone gives a certain capital to another person with a condition that it is returned with a certain gain. In this transaction, the capital itself would provide a return with no exchange of item. The return is purely to compensate for the deferment in which the owner gets his capital back. This return is classified as *riba*. One of the basic principles of Islamic finance is "no risk, no gain" (Ahmed, 2010).

In buying and selling, the buyer gets the satisfaction of owning an item while the seller gets the return for his hard work. While in *riba*, the lender gets capital gain but the borrower gets nothing but only the deferment in returning the capital plus interest. If the borrower uses the loan for his personal interest (like buying an expensive medicine for a sick child) he gets no gain in this transaction except for the item that he bought that will expire. If the borrower uses the money for business activities, he might make profit but there is still a chance that he might fail in his endeavour. This kind of transaction is one sided on behalf of the lender. In normal business activities, humans make profit by utilizing their time and skills. In *riba*, the lender gets a guaranteed profit from other people's effort without having to have any skills or using up time. The lender is shielded from the risk of losses that the borrower faces. This is lopsided and can lead to oppression. In Islam, both the financier and the entrepreneur must equitably share both the profit as well as the loss (Chapra, 2009).

While Islam allows for debt financing, it prohibits the creation of debt through direct lending and borrowing. In *murabaha*, which is equivalent to 'cost-plus financing' or 'mark-up financing', the seller reveals the true cost behind the product and sells it at an agreed marked-up price to the customer. Payment can be at spot or in the future. According to Kumar (2008), *murabaha* is a sales contract and must abide by the requirements of a valid contract of sale under the Shariah law. It should consist of the elements below:

- The commodity should be certain and an existing commodity and not a future commodity which is going to be produced or cultivated;
- The seller must be the owner, either physical or constructive, at the time of sale;
- The sale cannot be conditional and must have a fixed consideration;
- The commodity must have value at the time of sale.

According to Chapra (2009) Islam allows the creation of debt through the sale (or lease) of real assets with the conditions listed below:

- The asset that is being sold or leased must be a real asset, and not imaginary or notional.
- The seller must have ownership and possession of the goods that are being sold or leased.
- The transaction must be an authentic trade transaction with the purpose of giving and taking delivery of the asset.
- The debt cannot be sold to another party. The risk associated with the debt must be borne by the lender.

"… the use of the depreciating currency as unit of account is the most important reason of the non-viability of the interest free dealings." (Rab, 2006)

## SUMMARY OF FINDINGS

This section summarizes the findings by depicting the differences between conventional and Islamic finance as discussed earlier. Table 3 (Appendix) presents the summary of the differences between conventional finance and Islamic finance.

Unlike capitalism, Islamic financing prohibits interests as stipulated in several verses in Al Quran and Hadith. In the *Surah Al-Baqarah* (275-281) establishes a clear distinction between interest and trade :

*"Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; ...this is because they say: "Trade is like interest" while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist, may have what has already passed, their case being entrusted to God; but those who revert shall be the inhabitants of the fire and abide therein for ever..."(*275)

The following verse shows interest deprives wealth of God's blessings**.**

*"That which you give as interest to increase the people's wealth increases not with God, but that you give in charity, seeking the goodwill of God, multiplies manifold*." (Surah Ar Rum:39).

Previous sections have elaborated on why and how interest rates can affect an economy negatively. Additionally, Islamic finance prohibits any uncertainties which could have adverse impact on an economy via speculation. An economy void of uncertainties would provide a strong base for business to flourish without any fears of huge fluctuations in its economic variables. By prohibiting *haram*, immoral, and unethical activities, Islamic finance ensures that an economy steer clear of any injustice and negative consequences arising from such activities. While the

conventional finance puts priority on maximization of one's utility, Islamic finance puts emphasis on the sharing of profits and risks between lenders and borrowers. Islamic finance works on the win-win environment rather than zero sum game. This would create a much softer landing for businesses in an economic slowdown. This is further strengthened by the abundance mentality, encouraged in Islamic finance. Islam emphasizes on the payment of *zakat* which means to 'purify the wealth' and redistribute to the needy as mentioned in the Al Quran, *Surah at Tawba* (103):
"*Take alms of their wealth, wherewith thou mayst purify them and mayst make them grow, and pray for them. Lo! thy prayer is an assuagement for them. Allah is Hearer, Knower."*

The investment activities should be based on profit and loss sharing. If one is not taking any business risk in a commercial activity, he or she does not deserve to receive any gains from it. This is why Islam encourages more equity financing (where the risk is spread among lender and borrowers) rather than debt financing (where the risk is solely borne by the borrower). These protect an economy from excessive lending, leverage and risk-taking.

Theoretically, the propositions of Islamic finance are be able to insulate any economy embracing it from the crises that are common in conventional finance nowadays. However, practically, the real essence of Islamic finance is quite difficult to be implemented fully, as the global economy is highly interdependent with each other. There are too many linkages between financial institutions, globally, that prevents the complete separation of the two systems and needs further thought and analysis in the broader effect of Islam finance concept in the future.

## CONCLUSION

In Islamic principles, each individual is encouraged to work and to ensure that all the sources of income and wealth are from legitimate (*Halal*) sources according to Islamic laws. This means that people should struggle for wealth and obtain the wealth as part of the tools to fulfill the purpose creation of man himself, *i.e.* to serve God, the creator. In contrast with the western's 'Maximizing shareholders' worth' concept in finance, Islam states that profit in business must be accompanied with responsibility, accountability and full disclosure. Unscrupulous profit taking using usury or *riba* activities is strictly prohibited in Islam. In terms of lending funds, Islam put emphasis on profit sharing in lending funds. If one is not taking any business risks, he or she has no right to its profits.

Buying and selling transactions occur when a seller provides an item to a buyer at a certain price, while usury (*riba*) occurs when someone gives a certain capital to another person with a condition that it is returned with a certain gain. Islam prohibits usury or *riba* due to its repercussion but allow trading and profits gained from legitimate sources. It is obvious that interest (usury) is one of the major causes of the financial crises in the West. The American subprime crisis and European sovereign debt crisis are the evidence of "ruined" capitalism and now, the next best alternative to be looked upon is the beneficial value of Islamic finance. Over-consumption, over-leverage, and bad governance have turned what used to be the superpowers of modern finance into impoverished states. On the other hand, Islamic finance, which combines the spiritual and the material (with emphasis on spiritual values and social justice), can give rise to an economy that is sustainable.

In a conventional banking system, due to the interest that is being exacted, resources cannot be fully utilized as the funds, that are available, are discounted by an interest fee. As such, not only usury is not acceptable in Islam it would also cause destruction in any economic system that embraces it. Islam aspires to establish justice between the financier and the entrepreneur. The prohibition of *riba* is important to ensure justice in an economy, to remove all forms of exploitation through unfair exchanges, and to develop a *riba*-free economy. It is vital to close all back doors to *riba* because in Islamic law, anything that serves as means to the unlawful is also unlawful.

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**APPENDIX**

Figure 1: Scarcity Mentality

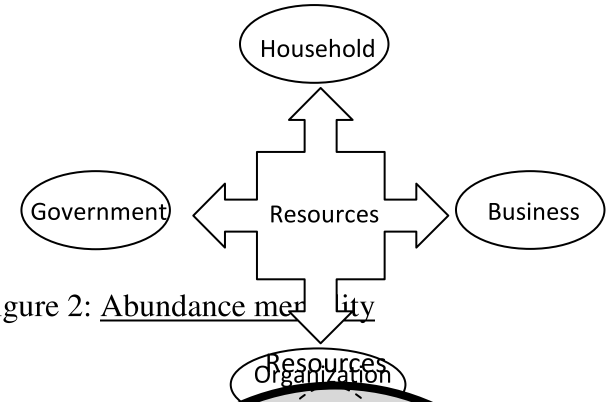


Figure 2: Abundance mentality

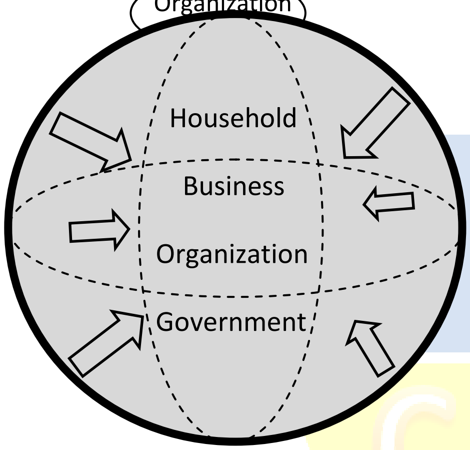

Figure 3: Islamic Banking

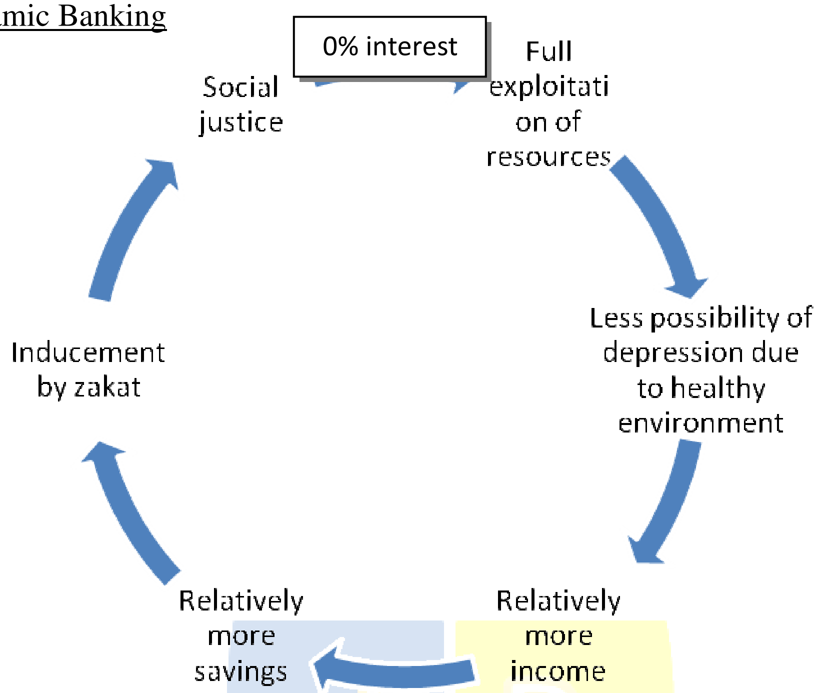


Figure 4: Conventional Banking

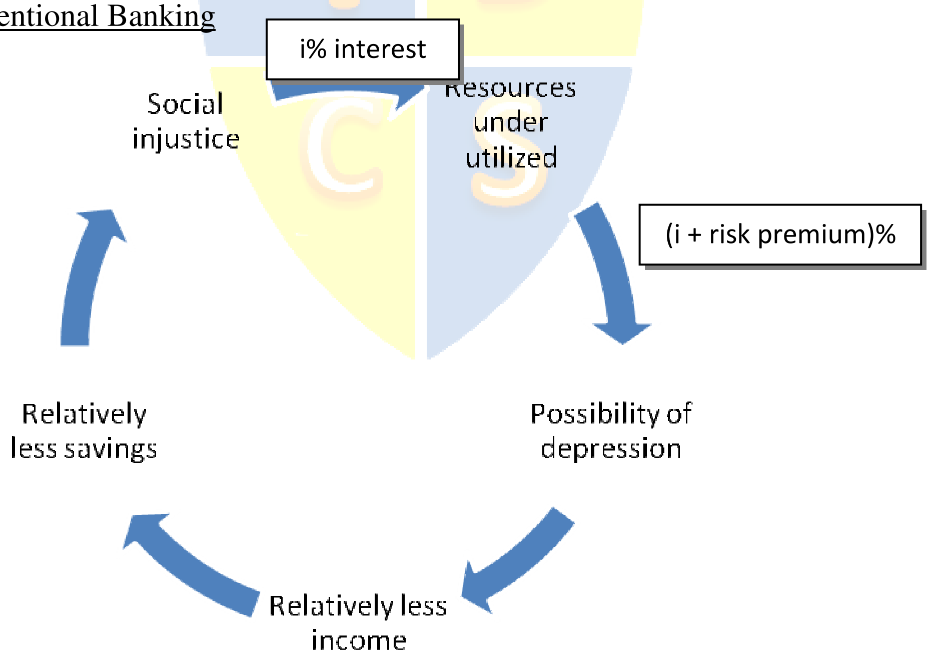

Table 1: Comparison between Conventional and Islamic Finance

| Conventional Finance | Islamic Finance |
|---|---|
| Too much debt. | Equity rather than debt. |
| Overleveraging of assets. | Financing in strict relation to assets rather than leverage. |
| Excessive securitization and creation of new assets that was neither transparent nor understood. | Transparency and information sharing between investor and the manager. |
| Diversification of risk, based on unreal models; all leading to massive systematic risk, the too big to fail (TBTF) problem and the need for bailouts. | Diversification of risk by risk sharing. |

(Source: Matthews and Tlemsani , 2010)

Table 2: Difference between money and commodity.

| Money | Commodity |
|---|---|
| Does not possess an intrinsic value. Only a measure of value or a medium of exchange. | Possess intrinsic value. Can fulfill human needs directly by itself. |
| Quality stays the same. | Can differ in quality. |
| Different denominations could have the same value. | Transactions are done by identifying the items of interest. Each item is unique. |

(Source: Hassan, 2007)

Table 3: Difference between conventional and Islamic finance.

| | Conventional finance | Islamic finance |
|---|---|---|
| 1 | Based on man-made principles | Based on Shariah (Islamic law) principles. |
| 2 | Interest (*riba*) based | Interest is prohibited. |
| 3. | Uncertainties (*Gharar*) such as speculations activities are prevalent | Uncertainties are minimized. Speculations are not allowed. |
| 4. | Gambling (*Maisir*) activities exists (such as lottery, horse race etc.) | Any activity that resembles gambling is not permissible. |
| 5. | May involve Prohibited (*Haram*) activities | Investments in prohibited (*Haram*) activities such as, liquor producing are not allowed. |
| 6. | Immoral/unethical activities may exist. | Financing and investment in immoral activities such as fraud, gambling, and money laundering are not allowed. |
| 7. | Separates the spiritual concept and the material. | Puts great emphasis on both spiritual values and social justice. |
| 8. | Zero sum game. Gains in one party have to be followed by losses on another party. | Win-win situation for both parties; the entrepreneur and the financier. |
| 9. | Focus on maximization of individual utility, welfare, and choice. | Focus on the equitable shares among the entrepreneur and financier. (e.g. profits and risks are equitably shared by both partners with mutual contract) |
| 10. | Scarcity mentality, based on the idea of limited resources. | Abundance mentality where resources are bountiful and available for sharing. In Islam, wealth is not the main objective of life, but is the mean to success in life, that is, to achieve total submission to God (*redha*). |
| 11. | Higher and inconsistent tax rate system | The rate is fixed. Imposition of *Zakat* system - Islam emphasizes the religious levy to the rich people (rate 2.5%) and distribute it to the poor masses *(asnaf)* as part of the equal distribution of wealth. |
| 12. | Interest is viewed as gain and counted in the profit calculation. | Interest is not considered as profit. Profit arises from the business/trading activities where there is a physical sale transaction. |
| 13. | Money is treated as commodity | Money is a medium of exchange and cannot be treated as commodity. |
| 14. | High risk, high return. | Profit and loss sharing concept. No risk, no gain (*Al ghannam bil ghurm*) |
| 15. | Emphasizes more on debt financing. | Emphasizes more on equity financing. |