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## WHY AN INTEREST-FREE ECONOMY WAS INSTITUTED FROM EARLY RELIGIOUS ZEAL

Romi Adetio Setiawan\*

**Abstract:** Throughout the 20<sup>th</sup> century, proponents of Islamic economics put forward the establishment of a modern banking system (and Islamic economic system) that adhered to Sharia principles and banned all forms of *riba* (interest). Greater attention was given by various reformist scholars to Islamic banking and finance in the 1960s and 1970s, and has continued to grow since then. The restriction on *riba* also prevailed even among non-Muslims and the origins of interest prohibition can be traced to the Jewish and Christian faiths. However, the issue of prohibiting interest in modern financial systems is still a matter of debate among Islamic jurists and often causes confusion and inconsistency as to cases when *riba* can be applied. While *riba* is expressly prohibited in all aspects of religion in a classical religious context, the modern practice of the interest system in Islamic finance is still debated in the context of a contemporary society.

**Keywords:** *riba, interest-free, Islamic, economy*

### INTRODUCTION

At several points in their history, charging interest used to be prohibited by scholars in the three Abrahamic faiths; however, in the cases of Judaism and Christianity, the early blanket prohibitions were eventually modified or overturned by later scholars/authorities for various reasons.<sup>1</sup> Islamic scholars realise it is not Islam alone that had denounced interest on loans and introduced an interest-free system.<sup>2</sup> The revelation of the Qur’ān in the teachings of Muhammad links to the teachings of Moses and Jesus in many spheres, including the charging of interest.<sup>3</sup> It is important to study and reflect on the history of the prohibition of interest from the classical religious texts in the Torah, the Christian bible and the Qur’ān to see how these disciplines developed over time and were modified to meet the needs of financial institutions in the contemporary society context. However, it is arguable in what follows, as there is no account of the arguments made by scholars – especially in Christianity, first by Catholic then

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<sup>1</sup> Odd Langholm, *The Legacy of Scholasticism in Economic Thought: Antecedents of Choice and Power* (UK: Cambridge University Press, 1998), 62; Diana Wood, *Medieval Economic Thought* (UK: Cambridge University Press, 2002), 183; Charles R. Geisst, *Beggar Thy Neighbor: A History of Usury and Debt* (Philadelphia: University of Pennsylvania Press, 2013), 273.

<sup>2</sup> Abdul Azim Islahi, “History of Islamic Banking and Finance,” *Journal of Intellectual Discourse* 26, no. 2 (2018): 407.

<sup>3</sup> Yania Abdul-Rahman, *The Art of Islamic Banking and Finance: Tools and Techniques for Community-Based Banking*, 2nd ed. (Hoboken, NJ: John Wiley & Sons Inc, 2014), 19.

Protestant reformers – for modifying the prohibition on interest to permit the charging of interest in some cases. As noted by some commentators such as Langholm and Wood, in Judaism, “brother/neighbour” came to be interpreted as “coreligionist only,” thereby allowing interest to be charged to non-Jews; in Christianity, interest on commercial investment loans came to be deemed fair, but was prohibited for consumption loans; and later, only unduly high interest rates were deemed “usurious.”<sup>4</sup> However, it is worth noting Geisst’s point that the Christian debates over the prohibition on interest mirrors, in some respects, contemporary Muslim debates over innovations in Islamic finance.<sup>5</sup>

From a Judaism perspective, the prohibition of charging interest/usury in the transaction was to prevent exploitation of the poor and needy, leading to property loss on default. Usurious acts in ancient Egypt became widespread among the Hebrews, because of the practice of *ribit/neseq* (the term used in the Torah to refer to usury/interest).<sup>6</sup> *Ribit* was a fee charged on money loaned to the poor to buy seeds or meet their daily needs. At this time, Moses was taught by God to remove *ribit* from society, as revealed in the Torah and later elaborated in the Talmud (the compilation of Jewish civil and ceremonial law and legend) by the learned rabbis. Under the leadership of Moses, *ribit* was prohibited and the Hebrews were restored to their freedom and established new settlements and farmlands.<sup>7</sup>

People of the Jewish faith abide by the Jewish bible or Torah, which is acknowledged in the Qur’ān. Jewish people believe the Torah was revealed by God to Moses and is considered as the main source of the Jewish law.<sup>8</sup> The legal discussion of interest/usury (*ribit* or *neseq*) is found in the book of Exodus, chapter 22, verses 24-26: “When you lend money to any of my people, to the poor among you, you shall not be to him as a creditor, nor shall you impose upon him any interest.” It is clearly expressed that taking interest is against Jewish law. According to rabbinical interpretation, not only is the lender prohibited from charging interest, the borrower is also prohibited from offering to pay interest.<sup>9</sup> However, this prohibition is only applied among those who are Jewish. Deuteronomy 23:20 points out that Jews can charge interest to a foreigner but not to their fellow Jew, because it is considered against the responsibility of brotherhood to a fellow human and the poor.<sup>10</sup>

In early Christianity, the practice of usury was rampant when Jesus was appointed to preach God’s teachings; Jesus propagated the prohibition of usury on monetary loans to the poor and needy, and condemned the practice of charging interest as a tool to confiscate the collateral properties of those with less money and enslave the poor if they were unable to pay back their debt as agreed.<sup>11</sup>

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<sup>4</sup> Langholm, *The Legacy of Scholasticism*, 64; Wood, *Medieval Economic Thought*, 184.

<sup>5</sup> Geisst, *Beggar Thy Neighbor*, 275.

<sup>6</sup> Abdul-Rahman, *The Art of Islamic Banking*, 16.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid., 21.

<sup>9</sup> Ibid., 27.

<sup>10</sup> Walter C. Kaiser, Tremper Longman and David E. Garland, *Exodus: The Expositor’s Bible Commentary* (California: Zondervan, 2017). In the Laws of Society, Exodus 22:16-31.

<sup>11</sup> Abdul-Rahman, *The Art of Islamic Banking*.

The Christian bible comprises the Jewish scriptures in the Torah, which is traditionally referred to as the Old Testament, and the documented writings from the period of Jesus and just afterward, which is referred to as the New Testament.<sup>12</sup> St. Thomas Aquinas, in his *Summa Theologica*, writes: “To take usury for money lent is unjust in itself, because this is to sell what does not exist, and this evidently leads to inequality which is contrary to justice.”<sup>13</sup> Charging interest is also condemned by the Roman Catholic tradition, such as by St. Ambrose (d. 397), St. Jerome (d. 420) and St. Augustine (d. 430).<sup>14</sup> Canon 13 of the Second Lateran Council (1139) states:

Furthermore, we [Catholics] condemn that practice. It is looked upon as despicable and blameworthy by divine and human laws, denounced by Scripture in the old and new Testaments. Namely; the ferocious greed of usurers; and we sever them from every comfort of the church, forbidding any archbishop or bishop, or an abbot of any order whatever or any one in clerical orders, to dare to receive usurers, unless they do so with extreme caution; but let them be held infamous throughout their whole lives and, unless they repent, be deprived of a Christian burial.<sup>15</sup>

Usury is also banned by several popes, including Alexander III, Gregory IX, Urban III, Innocent III and Clement V.<sup>16</sup> However, for the contemporary Roman Catholic Church, most theologians approve of taking interest on money loaned and interest is relaxed as long as it is not excessive. Although the Church maintains that taking usury is wrong, it does not mean that charging money beyond the principal is wrong, as noted in the Germain Grisez and John Noonan documents.<sup>17</sup>

The eradication of loaning money for interest or usury is also stated in documents from the late 15<sup>th</sup> century, during the time of the Protectorate under the administration of England King Edward VI, son of King Henry VIII, who ruled from 1547 and was England’s first fully Protestant monarch. Under his reign, the prohibition on usury was re-implemented in the Laws of England, which was last implemented by English Catholic King Henry VII in 1495 and is recorded as the most stirring documents authored against usury.<sup>18</sup>

During the earliest days of Islam, Arab society was at the dawn of the commercial age, as usury (charging interest on loaned money) was expanding. To restore equitable life and fairness in trading, *riba* was strictly prohibited in Islamic teachings from this time.<sup>19</sup> Muslims believe the Qur’ān is the revelation of God and it is God’s last and final revelation to mankind. They

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<sup>12</sup> Ibid., 21.

<sup>13</sup> Thomas Aquinas, *Summa Theologica: Second Part of the Second Part* (Ontario, Devoted Publishing, 2018), 322.

<sup>14</sup> Robert P. Maloney, “The Teaching of the Fathers on Usury: An Historical Study on the Development of Christian Thinking,” *Vigiliae Christianae* 27, no. 4 (1973): 259-260, accessed June 25, 2021, doi: 10.2307/1582909.

<sup>15</sup> Frances Spilman, *The Councils of the Catholic Church: Nicea to Now* (Raleigh: The Goldhead Group Ltd, 2015), Lateran Council III, 1139.

<sup>16</sup> Abdul-Rahman, *The Art of Islamic Banking*, 30.

<sup>17</sup> William B. Smith and Donald Haggerty, *Modern Moral Problems: Trustworthy Answers to Your Tough Questions* (San Francisco: Ignatius Press, 2012), 241.

<sup>18</sup> Abdul-Rahman, *The Art of Islamic Banking*, 17.

<sup>19</sup> Ibid.

also believe the revelations of Moses in the Torah and Jesus in the Bible are affirmed in the Qur'ān and all other prophets of God's teachings, including Abraham, Isaac, Ishmael, Jacob, David and Solomon.<sup>20</sup> Part of the creed of a Muslim is that they have to believe and honour Moses and Jesus, as mentioned in the Qur'ān: "Of some apostles We have already told thee the story; of others We have not; and to Moses God spoke direct."<sup>21</sup> The teachings of Moses and Jesus were aimed at worshipping only one God, followed by intensifying people's commitment to God by softening their heart toward those who are poor and in need, and making it easier for all people whether rich or poor to live together in peace and justice. Prophet Muhammad was commissioned by God to expand on the teachings brought by Abraham, Moses and Jesus and provide comprehensive teachings on how to live, build a community, raise a family, govern and be fair in business.<sup>22</sup>

In Islam, no additional benefit can be taken from an indebted person because this is implied interest over the original value owed; the dignity of the borrower should be preserved by never telling others, disclosing their financial situations and respecting their privacy; and Muslims are encouraged to forgive loans if the borrower is heavily indebted.<sup>23</sup> The House of the Treasury (Bayt ul-Maal) is also made available for collecting alms (*zakah*) from Muslims and uses this money to release those who are heavily indebted. According to Sharia laws, the lender is required to forgive a loan if the indebted person dies and their family cannot meet the demand.

Given the above prohibition of taking interest (*riba*) in all classical religious contexts and the common practice of charging interest in the present day, perhaps the ordinary practices of taking interest in the contemporary financial industry occurred due to the relaxation of interest laws by the contemporary Church, where taking interest is permitted as long as the charges are not judged excessive. In the classical context, the Church affirmed the Old Testament that lending with interest is disapproved with respect for care of the needy. However, the Jews developed the use of interest in finance to obtain capital in business activities, based on the Torah in Deuteronomy, which allows them to charge interest to foreigners. When financial institutions began to lose the idea of caring for the needy and poor, higher rates of lending in commercial purposes became inevitable. In the early 20<sup>th</sup> century, this concept of commercialisation was realised by Muslim scholars, who were astounded at the current condition of the financial system, as they found this system was comparable to the previous ages before prophethood Muhammad in ancient life in Makkah where the practice of usury was common.<sup>24</sup>

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<sup>20</sup> Ibid., 22.

<sup>21</sup> Qur'ān 4:164.

<sup>22</sup> Abdul-Rahman, *The Art of Islamic Banking*, 19.

<sup>23</sup> Ibid., 25.

<sup>24</sup> Islahi, "History of Islamic Banking," 403.

## THE IMPLEMENTATION OF INTEREST-FREE LOANS IN THE CLASSICAL ISLAMIC PERIOD

Charging interest is described as one of the most grievous sins in Islam. The condemnation of *riba* appears to be consistent from the early period of the Prophet and this is clearly mentioned in the Qur'ān: "O ye who believe! Devour not usury, doubled and multiplied; but fear God that ye may (really) prosper."<sup>25</sup> The Qur'ān prohibits *riba* in at least four surahs: al-Rum (30:39), al-Nisa' (4:161), al-'Imran (3:130-132) and al-Baqarah (2:275-281). The condemnation of *riba* in Islam is also mentioned in *ahadith* during the Prophetic period, such as narrated by Jabir: "The Prophet PBUH cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said: "They are all alike (in guilt)."<sup>26</sup> Therefore, in Islam, it is more valuable to foster mutual caring, give to the poor and needy, and help their life by giving alms (*zakah*).

### *The Prophetic Period*

Interest-free borrowing and financing of commercial activities can be traced to the early Islamic period at the centre of Makkah. Profit and sharing practice were also common among businesspeople and traders, even before Muhammad's prophethood (*risalah*). Prophet Muhammad engaged in trading with financial capital supplied by Khadijah. This practice is known as partnership (*mudharabah*), where the capital is provided by the owner and the manager is obliged to run the business according to their skill, using a profit and loss sharing provision.<sup>27</sup> The challenge at the time of Prophet Muhammad was how to measure the price of items when a commodity could be measured using more than one method (size, number and weight). For example, in terms of exchanging rice, high quality rice is different from normal quality rice, because it has more fragrance and the grains are larger. Therefore, 100kg of normal quality rice cannot be exchanged for 50kg of high-quality rice, even with the weight reduced, because this type of transaction is considered as *riba* – the high-quality rice has more economic value because of demand in the market. However, an exchange can still occur by selling the item, then buying the high quality rice after selling the normal quality rice.<sup>28</sup> In this way, the practice of usury (*riba*) can be avoided, as it lays the foundation of fair pricing for products and services based on real market values. The common use of the profit and loss sharing system in that period was aimed at complying with the religious prohibition on interest on loans.

The development of Islamic banking and finance in the early Islamic period is evidenced by the establishment of the House of the Treasury (Bayt ul Mal); it was the first institution to mark the formal arrangement of Islamic financing. It collected alms and charity (*zakah*, *sadaqah* and *infaq*) from Muslims and distributed these to the poor. The foundation also provided benevolent

<sup>25</sup> Qur'ān 3:130.

<sup>26</sup> Muslim, *Sahih Muslim*, "The Book of MUSAQAH," hadith no. 1598, <https://sunnah.com/muslim>.

<sup>27</sup> Islahi, "History of Islamic Banking," 405.

<sup>28</sup> Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (Hoboken, Singapore: John Wiley & Sons, Incorporated, 2011), 73.

loans (*qard hasan*), as this type of loan is encouraged by the Prophet.<sup>29</sup> Apart from partnership contracts (*mudharabah* and *musyarakah*), another type of transaction – advance payment sale (*salam* contract) – was also practiced in the agricultural sector, where full payment is made in advance for goods (normally agricultural products) to be delivered at a future date.<sup>30</sup> These arrangements infer the Islamic system of financing in the early Islamic period provided alternatives to charging interest.

### ***The Post-Prophetic Period***

Islamic banking and finance also developed in the post-Prophetic period. The emergence of the four major Islamic schools of thought (*al-madhaahib al-arba'ah*) from the 9<sup>th</sup> century on ushered in a unique form of jurisprudential pluralism. The majority position on all four schools in the classical period was that *riba* in general (not just *riba al-jahiliyya/al-nasi'a*) was prohibited (although the Hanafi and Shafi'i schools differed from the rest on the issue of whether an entire contract was voided by the inclusion of *riba*).

*Riba* literally in Arabic means “usury or elevation.” It is an increase in wealth that is not related to engaging in productive activity.<sup>31</sup> It is also concerned with exploitative gains made in trade or financial transactions.<sup>32</sup> *Riba* practices in the pre-Islamic period (*riba al-jahiliyya*) involved adding debt due to a debtor's inability to repay on time, which is an unlawful type of *riba*.<sup>33</sup> Jurists from the various schools of law in this period have debated two types of *riba*, which are *riba al-nasi'a* and *riba al-fadl*. The former involves deferment of counter value and the latter relates to excess in counter value.<sup>34</sup> The four schools of law have different opinions about the use of *hiyal* (evasion) on the prohibition of *riba*. The Hanbali and Maliki schools completely reject *hiyal*; in contrast, the Hanafi and Shafi'i schools employ and develop *hiyal* in justifying the restricted interpretation of *riba*.<sup>35</sup> The debate over *riba* was mainly in the view of *riba al-nasi'a*, in which Ibn Qayim al-Jawziyya, the 14<sup>th</sup> century Hanbali school permitted *riba al-nasi'a* and considered it as manifest *riba* as opposed to hidden *riba*. Ibn Qayyim did not add *hiyal* in his argument as in the Hanbali school, the use of *hiyal* is void.<sup>36</sup> This seems to

<sup>29</sup> Wan Shahdila Shah Shahar et al., “The Historical Development of Islamic Banking” (paper presented at the 4th International Conference on Management and Muamalah Putrajaya, Malaysia, November 7, 2017), 505; Ahmad Kaleem and Mervyn K. Lewis, “Non-Interest Financing Arrangements in Three Abrahamic Religions,” in *Risk and Regulation of Islamic Banking*, ed. Marvyn K. Lewis, Muhamed Ariff and Shamsher Mohamad (UK: Edward Elgar Publishing, 2014), 164.

<sup>30</sup> Shahar et al., “The Historical Development of Islamic Banking.”

<sup>31</sup> Abdulkader Thomas, “What Is *Riba*?,” in *Interest in Islamic Economics: Understanding Riba*, ed. Abdulkader Thomas (London: Routledge, 2006).

<sup>32</sup> Mumtaz Hussain, Asghar Shahmoradi and Rima Turk, *An Overview of Islamic Finance*, IMF Working Paper no. WP/15/120 (Washington, DC: International Monetary Fund, 2015), 7, <https://www.imf.org/external/pubs/ft/wp/2015/wp15120.pdf>.

<sup>33</sup> Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*, 2nd ed., Studies in Islamic Law and Society (Leiden: E.J. Brill, 1999), 23.

<sup>34</sup> *Ibid.*, 35.

<sup>35</sup> Thomas, “What Is *Riba*?,” 125.

<sup>36</sup> Emad H. Khalil, “An Overview of the Sharia Prohibition of Riba,” in *Interest in Islamic Economics: Understanding Riba*, ed. Abdulkader Thomas (London: Routledge, 2006), 58.

indicate that Ibn Qayyim may have relaxed the strict prohibition of *riba* in an effort to stem rampant use of *hiyal* occurring at that time.<sup>37</sup>

In terms of actual practice, historians have found instances from the 16<sup>th</sup> century onward of money lenders in the Ottoman Empire openly charging interest on loans and distinguishing this from ‘usurious’ (unduly high) interest rates; this practice seems to have been tolerated by religious authorities.<sup>38</sup> Arguably, this was due to Grand Mufti Mehmet Ebussuud Efendi’s fatwa in the 16<sup>th</sup> century permitting interest-based lending for Islamic charity organisations on pragmatic *maslahah* (public interest) grounds.<sup>39</sup> However, this practice seems not to have been prevalent in pre-partition India and the Malay Archipelago among Muslims, but ‘conventional’ banking institutions were established and dominated these areas in the colonial period.<sup>40</sup> Later, in the 1840s, the Ottoman state, nominally ruled by the khalif, began issuing interest-bearing treasury bonds.<sup>41</sup>

## MODERN ERA INTEREST-FREE SYSTEM IN FINANCIAL INSTITUTIONS

There are two rationales behind establishing a modern Islamic banking system. The first is typified by awakening Muslim experts’ position after the freedom from the era of colonialisation. The second is the objection of Islamic scholars to the common practice of interest in Western banking, which provided the impetus for an interest-free banking system. These reasons are elaborated below.

During colonialisation, the gap between the West and Arabs and other Muslim countries was evident in all spheres, including education, science, technology, politics and economics. With freedom from colonialism, Muslim states began to rectify the situation by establishing scientific and educational institutions, reforming economic thinking and reviving creative thinking.<sup>42</sup>

Muslim scholars were open to learning from the Western financial model but expressed objections to the practices of the Western banking system and developed an interest-free system of banking.<sup>43</sup> However, the Western banking system practices had become common and even dominated major Muslim countries in almost all types of business activities as they were inherited from the colonialists. This condition is an identical challenge for Islamic scholars, because changing a mindset is harder than changing a concept. Many Muslims had become familiar with the Western financial business model, as compared to Sharia-compliant business activities.

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<sup>37</sup> Ibid., 60.

<sup>38</sup> Suraiya Faruqi, “Crisis and Change: 1590-1699,” in *An Economic and Social History of the Ottoman Empire*, ed. Halil Inalcik and Donald Quataert (Cambridge: Cambridge University Press, 1997), 413.

<sup>39</sup> Ibid.

<sup>40</sup> Jusuf Wanandi, “Islam in Indonesia: Its History, Development and Future Challenges,” *Asia-Pacific Review* 9, no. 2 (2002).

<sup>41</sup> Murat Cizakca, *A Comparative Evolution of Business Partnerships: The Islamic World & Europe, with Specific Reference to the Ottoman Archives* (Leiden: E.J. Brill, 1996), 187.

<sup>42</sup> Islahi, “History of Islamic Banking,” 415.

<sup>43</sup> Ibid., 412.



Only in the late 20<sup>th</sup> century was there an awakening in thinking about Islamic economics and the prohibition of interest. The ban of *riba* in banking became a popular topic among contemporary Islamic scholars and, as a result, many academics proposed theoretical grounds for establishing modern Islamic banks.<sup>44</sup> Muslim scholars, such as Mawdudi in the 1930s, wrote against charging interest and the ban of *riba* in banking and economics, often related to the price of money and the real demands of consumers in the market.<sup>45</sup> He also proposed the establishment of interest-free financing and argued the state should be involved in the arrangement of interest-free loans at national and international levels.<sup>46</sup> The attempt to establish Islamic financial institutions was initially started in Malaysia in the mid-1940s and Pakistan the late 1950s. Both were unsuccessful, however, due to factors mainly related to the inadequate operational system and poor management.<sup>47</sup> A second attempt was made in the 1960s and this was successful; this success marked the first milestone of modern Islamic banking and finance activities.<sup>48</sup>

In 1963, the first modern Islamic financial institution was established in Egypt called Mit Ghamr Saving House.<sup>49</sup> It was the first example of commercial banking organised on a non-interest basis. Its purpose was to provide finance for agricultural purposes in rural areas. Mit Ghamr was successful in meeting the financial needs of the rural population based on profit and loss sharing; however, it was taken over by the Egyptian government in 1967 due to political reasons and converted into a full interest-based bank.<sup>50</sup>

In the same year (1967) in Malaysia, Tabung Haji Malaysia was established to provide savings and investment services for Muslims.<sup>51</sup> Unlike Mit Ghamr, Tabung Haji aimed to relieve financial hardships so Muslims could perform their pilgrimage to Makkah; this was achieved by delivering returns on pilgrim's deposits. Tabung Haji flourished and enjoys a favourable political environment. It is a non-bank financial institution and acts as a finance company that invests the savings of their depositors in accordance with Sharia.<sup>52</sup>

In 1975, finance ministers from all Muslim countries met and approved the establishment of Islamic Banking Development, which was recognised as the first international Islamic bank established by 22 Islamic countries, known as the Organisation of Islamic Cooperation (OIC).<sup>53</sup> Following this, Islamic banks were established in OIC member countries. Dubai Islamic Bank was formed in 1977 and Bahrain Islamic Bank in 1979. Throughout the 1980s, several financial institutions were established in Muslim countries as well as in Europe where ANZ established

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<sup>44</sup> Ibid., 16.

<sup>45</sup> Ibid., 416.

<sup>46</sup> Ibid.

<sup>47</sup> Shahar et al., "The Historical Development of Islamic Banking," 506.

<sup>48</sup> Ibid.

<sup>49</sup> Saeed, *Islamic Banking and Interest*.

<sup>50</sup> Islahi, "History of Islamic Banking and Finance," 418.

<sup>51</sup> Shahar et al., "The Historical Development of Islamic Banking," 507.

<sup>52</sup> Ibid., 507

<sup>53</sup> Islahi, "History of Islamic Banking and Finance," 419.

Global Islamic Finance in 1989.<sup>54</sup> In Malaysia, Islamic banking at a larger scale started with the establishment of Bank Islam Malaysia Berhad in 1983, which is a fully fledged Islamic commercial bank.<sup>55</sup> Later in the 1990s, the first Indonesian Islamic bank (Bank Muamalat Indonesia) was established with investments from local and foreign investors and has become an alternative system for investment for the Indonesian economy.<sup>56</sup> A dual banking system started to operate, allowing conventional banks to offer Islamic banking products and services by operating separate units or windows; these units can be converted into full Islamic banking upon meeting the minimum capital assets requirement set by the regulators.<sup>57</sup>

## THE INTERPRETATION OF INTEREST UNDER CONTEMPORARY SHARIA

This section focuses on interpretations by contemporary Islamic organisations that issue *fatawa* (Islamic rulings given by qualified legal scholar) on *riba*, especially in South-east Asia (Malaysia and Indonesia). The positions that accept the broad interpretation of *riba*, but argue for leniency in the prohibition of it, will be discussed in the first section, while the second section examines debates over whether the concept applies in certain cases (such as for a return on deposits).

### *Leniency toward Interest Prohibition*

As mentioned in the above section, under classical *fiqh*, all forms of interest are *riba* and prohibited. This is based on the Qur'ānic verse: "If the debtor is in difficulty, then delay things until matters become easier for him; still, if you were to write it off as an act of charity, that would be better for you, if only you knew."<sup>58</sup> However, a more lenient interpretation of prohibition against *riba* adds a layer of ambiguity, as contemporary scholars note that Sharia law offers room for an alternative form that substitutes for claiming interest.<sup>59</sup> Arfazadeh, for example, states that interest in Islamic finance can still be applied where there is no remedy that could constitute valuable substitutes for a claim of interest; such claims can be taken in the form of damages, penalty payments and late performance.<sup>60</sup> On the other hand, the resolutions and recommendations of the Islamic Fiqh Academy Conference in Jeddah affirm the practice of charging a penalty is not permissible when the debtor delays the payment of instalments after the specified date. This is considered *riba*, because charging any amount in addition to

<sup>54</sup> Tariq Alrifai, *Islamic Finance and the New Financial System: An Ethical Approach to Preventing Future Financial Crises* (Singapore: Wiley, 2015), 48.

<sup>55</sup> *Ibid.*, 14.

<sup>56</sup> Abdullah Saeed, "Indonesian Islamic Banking in Historical and Legal Context," in *Indonesia: Law and Society*, ed. Tim Lindsey (Leichardt, NSW: The Federation Press, 1999), 324.

<sup>57</sup> Khalid Rahman and Mushfiq Ahmed, *Towards Islamic Banking Experiences and Challenges: A Case Study of Pilgrims Management & Fund Board, Malaysia* (Islamabad: Institute of Policy Studies, 2000).

<sup>58</sup> Qur'ān 2:280.

<sup>59</sup> See Maria Bhatti, *Islamic Law and International Commercial Arbitration* (Milton: Routledge, 2018), 170.

<sup>60</sup> Homayoon Arfazadeh, "A Practitioner's Approach to Interest Claims under Sharia Law in International Arbitration," in *Interest, Auxiliary and Alternative Remedies in International Arbitration*, ed. Filip De Ly and Laurent Levy (France: International Chamber of Commerce, 2008), 213.

the principal liability, regardless of whether it is mentioned in the pre-agreed contract, is similar to *riba* and not permitted in Sharia.<sup>61</sup>

The differences of scholars' opinion about interest in the context of compensation, damages and late payment charges is based on the interpretation of the Qur'ānic verse: "if you were to write it off as an act of charity, that would be better for you, if only you knew."<sup>62</sup> Based on this, although penalty provisions may be included in the contract agreement, charging a penalty in relation to a debt is characterised as *riba*.

The view of charging interest in the form of a penalty is also recommended by Taqi Usmani, who argues that charging interest can be used for claiming a penalty caused by late payment, damages or claiming the disgorging profits made by the defaulting party in the modern financial system, on the condition that the penalty amount is not compensation for damages or suffered by a party and the fee received from the defaulting party should be accepted as a charity and go to a charitable fund.<sup>63</sup> His argumentation was based on the Maliki school of thought, which states the defaulting party shall pay the dues of default payments based on the sum calculated in percentage per annum for each day of default to the charitable fund as suggested by the bank, unless the bank found the default was caused by poverty, which is beyond their control.<sup>64</sup>

This approach is also taken by international standards setting bodies in Islamic finance, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). As mentioned in AAOIFI's standard no. 8, charging interest for late payment is permissible in the contract of *murabaha* and can be stipulated where the customer is undertaking a declaration to pay an amount of money or percentage of the debt on the event of a delay on their part when paying instalments on their due date.<sup>65</sup> The penalty amount is to be paid to a charity as it based on the Maliki school of thought, where if the client is in default condition and unable to pay an instalment on time as agreed in the specified date, they shall pay the penalty to a charity based on the percentage of each day of default, unless they have reasonable evidence that it is unavoidable or due to poverty.<sup>66</sup>

Interestingly, the Sharia Advisory Council (SAC) of the Central Bank of Malaysia has a different opinion by viewing it from *maqasid al-shariah* (goals or objectives of Sharia) and justification of *maslahah*, the SAC divides charging interest on late payment into two categories: penalty (*gharamah*) and compensation (*ta'widh*). While *gharamah* is to be paid to a charity, under *ta'widh* the amount charged for late payment and penalty can be taken by the

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<sup>61</sup> Islamic Development Bank and Islamic Fiqh Academy, *Resolutions and Recommendations of the Council of the Islamic Fiqh Academy 1985-2000* (Jeddah: Islamic Development Bank, 2000), 104.

<sup>62</sup> Qur'ān 2:280. M.A. S. Abdel Haleem, trans., *The Qur'an* (UK: Oxford University Press, 2004).

<sup>63</sup> Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Karachi, Pakistan: Idaratul Ma'arif, 1998), 57.

<sup>64</sup> *Ibid.*, 59.

<sup>65</sup> Accounting and Auditing Organization for Islamic Financial Institutions, *Shari'ah Standards* (Manama, Kingdom of Bahrain: Accounting and Auditing Organization for Islamic Financial Institutions, 2015), 214.

<sup>66</sup> Usmani, *An Introduction to Islamic Finance*, 59.

bank.<sup>67</sup> Although both terms are used for charging a late payment, the interpretation of the words is different: *gharamah* is an Arabic term defined as the penalty for a late payment and *ta'widh* means compensation for a late payment.<sup>68</sup> The SAC's opinion allows the use of *ta'widh* under Sharia based on the hadith of Prophet Muhammad that "procrastination (delay) in repaying debts by a wealthy person is injustice."<sup>69</sup> The SAC's view is also based on the rationale of *maslahah* that the imposition of a penalty by the bank to the customer for social needs may make the customer recklessly delay payment as they would feel no harm for defaulting without valid excuse.<sup>70</sup> Thus, the SAC expressly reserves the use of *ta'widh* to claim compensation for late payment and the nominal amount of *ta'widh* should be based on real losses calculated from the day the default started. However, the virtuous solution can be made if the debtor is genuinely in difficulty or unable to pay due to poverty and any other unavoidable causes.<sup>71</sup>

The SAC's principle of allowing charging late payment as income for the bank differs from the view of Islamic scholars such as the Islamic Fiqh Academy of Jeddah and AAOIFI, as mentioned earlier that compensation is the same as interest. In practice, implementing jurists' *fatwa* rulings is quite complex, often forcing Islamic financial institutions to seek assistance from Islamic experts, as their products resemble interest-based products in a conventional bank. Bhatti notes "while the Islamic finance contract was labelled as *murabaha*, in substance the contract was similar to a standard conventional contract charging interest (*riba*)."<sup>72</sup> Therefore, Islamic jurisprudence plays a crucial role when issuing Sharia-compliant products and each Islamic bank must appoint a board of Sharia scholars. This board interprets issues covered in Islamic financial operations, minimises Sharia compliance risks and oversees the term of transaction in the contract of Islamic finance to meet Islamic jurisprudence.

Similarly, some Islamic scholars, such as Wasil, have even issued *fatwa* allowing taking simple interest or small amount of interest is not *riba*, on account that it is taken for a mere form of profit sharing investment.<sup>73</sup> There is no clarity over the use of compound interest in the modern banking system, which is treated as *riba*, since the interest is sourced from the profit that is invested in various business activities.

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<sup>67</sup> Habib Ahmed, "Maqasid al-Shari'ah and Islamic Financial Products: A Framework for Assessment," *ISRA International Journal of Islamic Finance* 3, no. 1 (2011): 149.

<sup>68</sup> Securities Commission Malaysia, *Resolutions of the Securities Commission Shariah Advisory Council*, 2nd ed. (Kuala Lumpur: Securities Commission, 2004), [www.sc.com.my/wp-content/uploads/eng/html/icm/Resolutions\\_SAC\\_2ndedition.pdf](http://www.sc.com.my/wp-content/uploads/eng/html/icm/Resolutions_SAC_2ndedition.pdf).

<sup>69</sup> Muhammad al-Bukhari, *Sahih al-Bukhari*, "Loans, Payment of Loans, Freezing of Property, Bankruptcy," vol. 3, book 41, hadith no. 585, <http://sunnah.com/bukhari/43/16>.

<sup>70</sup> Securities Commission Malaysia, *Resolutions*.

<sup>71</sup> *Ibid.*

<sup>72</sup> Maria Bhatti, "Managing Shariah Non-Compliance Risk via Islamic Dispute Resolution," *Journal of Risk and Financial Management* 13, no. 1 (2019): 3.

<sup>73</sup> Sina Ali Muscati, "Late Payment in Islamic Finance," *UCLA Journal of Islamic and Near Eastern Law* 6, no. 1 (2007): 62.

### ***Criticism on Riba in Modern Islamic Finance***

The consistency of Sharia compliance across the services and products offered by financial institutions is rigid, because the scholars come from different sects or backgrounds, even though the conditions for dissenting opinions can occur between scholars within the same school (*madhab*). Although scholars agree *riba* is prohibited, as it is clearly mentioned in the Qur'ān, there are differences on the issue of interest in the modern banking system. The key issue is whether interest in the modern system of banking can be related to the interest (*riba*) activities in the classical period.

Islamic principles regard money as a medium of exchange, having no value in itself. Money created out of money is prohibited such that interest cannot be paid or be payable for deposits or loans.<sup>74</sup> Islamic scholars consider money as capital when it is invested in a business. However, when money is advanced to a business in the form of loan, it is considered a debt, not entitled to interest and should be repaid at similar value. Investment return is linked to shared risk taking and not the mere passage of time.<sup>75</sup> However, Islamic scholars are of different opinions in their legal reasoning (*ijtihad*) over interest in the modern banking system. For example, Indonesian scholars from Nahdlatul Ulama are in favour of interest and argue that interest in the modern banking system is not in the form of a loan (*qardh*) but in the form of partnership investment (*qiradh*). Where customers deposit their money as savings, the bank forwards this money into real economic activities through loan investment (*qiradh*) to generate income; in return, the bank earns profit and divides this profit in the form of interest based on a conventional time value of money calculation to those customers.<sup>76</sup> Scholars who are against interest state this rate of interest may be far less or more than the actual proportion of profits that the financier might have deserved. Although both parties agree and regard this system as fair, the facts are the increase, on one hand, and opportunity cost, on the other. This activity is categorised as *zhulm* (usury or unjust acts of exploitation).<sup>77</sup>

In line with this, the Indonesian Council of Ulama (Majelis Ulama Indonesia (MUI)) defines *riba* as elevation, where the lender earns additional money from the principal amount. The MUI uses a reference based on the Qur'ān “But if you repent, then you shall be entitled to [the

<sup>74</sup> Abu Umar Faruq Ahmad and M. Kabir Hassan, “The Time Value of Money Concept in Islamic Finance,” *American Journal of Islamic Social Sciences* 23, no. 1 (2006): 73.

<sup>75</sup> Hussain, Shahmoradi and Turk, *An Overview of Islamic Finance*, 7.

<sup>76</sup> Nahdlatul Ulama, the largest Islamic organisation in Indonesia, used classical books from the Shafi'i school in making the *fatwa*. The Indonesian scholars who in favour of bank interest from Nahdlatul Ulama include KH. Maimoen Zubair, KH. Abdurrahman Wahid (GusDur), Gus Muwafiq and Gus Baha. See Raudhatul Qur'an Wal Hadits, “Haramkah Bank?? Ulama NU Menjawab (KH. Maimoen Zubair, Gus Dur, Gus Muwafiq, Gus Baha)” [Is Bank Interest Haram? The Answer from NU Scholars], YouTube video, 16:57, November 3, 2019, [https://www.youtube.com/watch?v=qHkhkVbIp\\_U](https://www.youtube.com/watch?v=qHkhkVbIp_U).

<sup>77</sup> Another rival Islamic organisation in Indonesia is Muhammadiyah, which is the second largest religious organisation in this country. Their scholars argue that *riba* is defined as usury and occurs if there is an unjust exploitation in the activity of bank interest, but if no such exploitation occurs then bank interest is not *riba*, although there is an addition gain from the principal amount of money. Fathurrahman Djamil, *Metode Ijtihad Majelis Tarjih Muhammadiyah* [The Method of Ijtihad of Majelis Tarjih Muhammadiyah]. (Jakarta: Logos, 1995). See Mondher Bellalah and Omar Masood, *Islamic Banking and Finance* (UK: Cambridge Scholars Publisher, 2013), 16.

return of] your principal: you will do no wrong, and neither will you be wronged.”<sup>78</sup> Based on this, the MUI states any additional money coming from a loan (*qardh*), which is calculated from the principal amount, is considered *riba*.<sup>79</sup>

Yet there are many well-known Islamic scholars who feel that banking interest is not prohibited by Sharia. Modern commentators such as Fazlur Rahman Malik opine that the word *riba* in the Qur’ān is translated as usury, but it is not as simple for banking interest. He differentiates between the various forms of interest charges and concludes that interest is not *riba* unless it involves exploitation that ruins poor borrowers.<sup>80</sup> This type of transaction is certainly against the law and, if a bank in this modern time does such exploitation, then the government should take action to counter this moneylender practice. Consequently, the Grand Mufti of Dar al-ifta al-Misriyyah in 1997 also opined the controversial argument about bank interest. He publicly declared that bank interest is permissible as long as the money is invested in halal business activities.<sup>81</sup>

Given the criticisms and various interpretations of interest in the context of today’s world, the interpretation of *riba* requires more faithful and equitable goals to achieve human welfare. Since the debate on the prohibition of *riba* is centuries-long, it is valuable to historically understand the subject. The uncertainty on the definition of *riba* has resulted in vagueness about *riba* and its rules. As contemporary commentator Nyazee said, “a clear statement on the meaning of *riba*, in the form of definition, would be very helpful even for the banks, especially western banks. Unfortunately, no such definition has been framed.”<sup>82</sup>

The debates over the interpretation of Sharia have existed throughout the history of Islamic civilisation, and so has the issue of whether interest is prohibited from an Islamic point of view. However, a more consistent form of codified standard for Islamic finance needs to be set out. According to academic Bhatti:

Shari’a law can no longer be dismissed as a backward form of legal system with no modern application because it is a matter of conscience that plays a huge role in influencing the mindset of individuals living in the Middle East. However, at the same time, jurisprudential tools from within the Shari’a, such as the concept of *maqasid* (higher objectives of Shari’a

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<sup>78</sup> Qur’ān 2:279.

<sup>79</sup> Muhammad Yasir Yusuf, “Dinamika Fatwa Bunga Bank Di Indonesia: Kajian Terhadap Fatwa Mui, Muhammadiyah Dan Nahdlatul Ulama” [the Variety of Fatawa on Bank Interest in Indonesia: The Analysis of Fatwa Mui, Muhammadiyah and Nahdlatul Ulama], *Media Syariah* 14, no. 2 (2012): 156 [translated by author].

<sup>80</sup> Other Islamic modernist scholars who concur with the view of Fazlur Rahman Malik are Sa’id al-Najjar, Sayyid Tantawi and Muhammad Assad, who argue the goal is not to cause usury or exploit borrowers. See Abu Umar Faruq Ahmad, *Developments in Islamic Banking Practice: The Experience of Bangladesh* (US: Universal Publisher, 2010), 60.

<sup>81</sup> Muhammad Akram Khan, *What is Wrong with Islamic Economics?: Analysing the Present State and Future Agenda* (UK: Edward Elgar Publishing, 2013), 175.

<sup>82</sup> Imran Ahsan Khan Nyazee, *The Concept of Riba and Islamic Banking*, 2nd ed. (California: CreateSpace Independent Publishing Platform, 2016), 170.

law) consisting of *maslaha* (public interest), *ijtihad* (independent reasoning), and re-interpretation should be used in order to harmonize Shari'a law...<sup>83</sup>

As also argued by Calder, there is a possibility of an elective affinity between contemporary *fiqh* and liberal markets in Islamic jurisprudence, and through normative pluralism in *fiqh* the worldviews should be dynamic to meet the rapid growth of modern markets.<sup>84</sup> Therefore, when analysing the application of *riba*, it is arguable that Sharia is not stagnant but subject to conditions and is likely to evolve through its own sources of legal theories such as *maqasid sharia*, *ijtihad* and *maslaha*.

## CONCLUDING REMARKS

The focus of this article is not to discuss whether interest is *riba*; the issue is that the topic of *riba* often becomes bogged down and lenient in religious legalistic and scriptural sources. This article refers to the term classical religious context as a frame of literature on the Judeo-Christian-Islamic concept. Nevertheless, as discussed earlier, historical and social circumstances play a role in what may be constituted as unfair in a loan in any exchange that addresses contemporary issues. Some religious scholars in modern times have been inclined to deal with the term interest used in contemporary banking transactions, which can often cause confusion and inconsistency as to which case of *riba* can be applied to contemporary financial institutions.

Charging *riba* was condemned not only in the Islamic religion but also in other religions, especially to religions of Abrahamic descent – Judaism and Christianity – where interest is universally prohibited in their earliest forms. However, only Islam paved the way out from the practice of interest lending trap. The prohibition of interest (*riba*) in these religions was to prevent the rich from abusing the life of the poor and encourage them to live together in peace and equitable financing. With the increasing use of interest in the banking system, the contemporary Church relaxed the interest prohibition as long as the rate was not excessive. While in Judaism, it is allowed to charge interest on a foreigner, based on their religious literature. The interest system is becoming common in modern times and charging higher interest rates on loans payments is inevitable to unfairly enrich the owner of the money.

Proponents of Islamic economics realise that interest-based practices are similar to usury and a grave sin, while reviving interest-free practices rectify the practice of usury in financial institutions. Attempts at building Islamic banking began in the early 20<sup>th</sup> century then the practice of Islamic banking spread worldwide and became acceptable not only in Muslim populated countries but also outside the Muslim world. The notion of Islamic finance for ethical concerns and promoting equitable financing became popular and enticed conventional banks

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<sup>83</sup> Maria Bhatti, "Resolving Islamic Finance Disputes through Arbitration in the Middle East," in *The Growth of Islamic Finance and Banking: Innovation, Governance and Risk Mitigation*, ed. Hussain Mohi-ud-Din Qadri and Ishaq Bhatti (London: Routledge, 2019), 260.

<sup>84</sup> Ryan Calder, "Halalization: Religious Product Certification in Secular Markets," *Sociological Theory* 38, no. 4 (2020): 336.

to participate in the playing field, by offering Islamic financial services and products. Today, the modern Islamic banking growth is unstoppable, although their market and asset scale are still below conventional banks. However, their contributions to economic growth and financial system are invaluable in the history of finance.

Despite this flourishing development, Sharia should not be considered as rigid and frozen, as Islamic law is subject to multiple *fiqh* interpretations. The different views of Islamic experts in understanding cases of finance and notions in the sources of legal reasoning are subject to different legal views and opinions by Islamic scholars. Thus, a framed definition would solve these discrepancies and provide Sharia consistency in Islamic finance.



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