1st Ethical’s Guide to

Tax Planning Through Trusts

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Why Islam has prohibited Interest & Islamic Alternatives for Financing

Winners of the Shell Livewire:
‘UK’s Fastest Growing Business of the Year’ award
‘North-West Entrepreneur of the Year’ award

Tax Planning Through Trusts
Islam does not deny market forces or the market economy. Even the profit motive is acceptable to a reasonable extent. Private ownership is not totally negated. Yet, the basic difference between a Capitalist and Islamic economy is that in secular Capitalism, the profit motive or private ownership are given unbridled power to make economic decisions. Their liberty is not controlled by any divine injunctions. The evils emanating from this attitude can never be curbed unless humanity submits to divine authority and obeys its commandments in any case and at every price. This is exactly what Islam does. After recognising private ownership, profit motive and market forces, Islam has put certain divine restrictions on economic activities. These restrictions being imposed by Allah Almighty, Whose knowledge has no limits, cannot be removed by any human authority. All these prohibitions combined together have a cumulative effect of maintaining balance, distributive justice and equality of opportunity.

Retired Chief Justice Mufti Muhammed Taqi Usmani
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‘So lose not heart, Nor fall in despair, 
For you are bound to rise, If you are true in faith’
Al-Quran 3:139

‘The collapse of the global marketplace would be a traumatic event with unimaginable consequences. Yet I find this easier to imagine than the continuation of the present regime’
George Soros, Global Financier

This Booklet is an abridged version of a research paper on the same subject. The entire paper is available online at www.1stethical.com/publications
Introduction

Most prohibitions in Islam are easy to understand. The evil effects of alcohol, adultery or gambling are not difficult for us to comprehend both at an individual and at society wide level. However when it comes to ‘interest’, few Muslims can fully comprehend the evils of this vice, and thus the prohibition on interest does not appear to resonate with us as seriously as it could, both at an individual and at society level. We often fail to grasp the significance of interest in shaping world events. The latter half of the twentieth century was dominated by a ‘cold war’ between two competing economic ideologies.

By refusing to accept an interest based economic ideology, Islam is effectively presenting a viable alternative to the victor of the ‘cold war’, Capitalism.

The problems with interest may be deceptively difficult for us to appreciate, but the Ban on interest by Allah is absolute. In fact, so despised is Riba, that the unparalleled curse of a ‘declaration of war’ from Allah (SWT) & his Messenger (SAW) is directed towards those who refuse to give up interest.

Our intention through this booklet is to firstly study the definition & chronology of the prohibition of interest in the Qur’an. We will then move on to analyse the effects of interest on the Global economy. Finally we will introduce the Islamic Alternative to interest based financing, known as ‘Musharaka’, and exhibit a working model of this alternative. First though, let’s start at the beginning by defining interest.
The standard dictionary definition for interest is as follows:

'A charge made for a loan or credit facility'.

Seems innocent enough. At first glance it seems reasonable for a charge to be levied in exchange for receiving a loan. The capitalist system believes in money’s unbridled right to a return irrespective of the level of profit or loss generated by the project to which the money was loaned. This is by definition interest. Islam fundamentally disagrees with the above view; and instead proposes that if capital is lent on a ‘loan’ basis then it must be repaid with no excess; any excess being interest. If the lender seeks any return on his capital, then he must invest his funds by purchasing equity and partake in the losses, risks and rewards of business. Even to the neutral observer, the Islamic position presents superior logic. Idle capital will always be unproductively used when it is guaranteed a return. This is simply because capital will flow to those who posses the greatest collateral, not those with the most viable business projects. We will explain in due course how Islam says capital can be more efficiently used. But let us now revise our definition of interest. Indeed, what better way to define the term than from the Holy Qur’an. In Surah Baqarah, Allah dedicates a number of verses to interest; from them we can infer the following definition for interest;

'Any excess paid or received on the principal’

The prohibition on interest is bilateral. Neither can the borrower pay it, nor can the lender receive it. So whilst investing money is halaal and can generate a positive return, a loan can never generate a return in excess of the amount advanced.
There are 4 explicit references in the Holy Qur’an to interest. Cumulatively, they clarify Islam’s position on the subject.

‘The first ever verse revealed on Riba was Surah Ar-Rum, verse 39, where Allah says;

‘And whatever Riba you give so that it may increase in the wealth of the people, it does not increase with Allah’

The next occasion when interest is mentioned is in Surah Nisa, verse 161 where Allah says;

‘And because of their charging Riba, whilst they were prohibited from it’.

Then came the first explicit prohibition of Riba in 2 AH, around the time of the battle of Uhud. The commandment is found in Surah Al-Imran, verse 130 where Allah says;

‘O those who believe do not consume up Riba, doubled & redoubled’.

Shortly after the conquest of Makkah in 8AH, the most comprehensive and damning indictment of interest was delivered in the Qur’an in Surah Baqarah verse 275-280, where Allah says;

‘Those who take usury will not stand on the Day of Judgment except as he who has been driven mad by the touch of the Demon. ………….Oh you who believe give up what remains of Riba if you are believers. But if you do not then listen to the declaration of War from Allah & his messenger (SAW). If you repent, your’s is your principal and nothing more…………………..’

In the year 10 AH, The Prophet (SAW), in his famous last sermon at Mount Arafat said;

‘All interest obligation shall henceforth be waived. Your capital however is yours to keep. You neither wrong, nor be wronged. Allah has judged that there be no Riba and that all interest due to Abbas ibn Abd Al-Muttalib shall henceforth be waived’

Hadith

NB:
Riba: Is Arabic for interest
AH: Denotes After Hijrah
‘The modern Banking system manufactures money out of nothing. The process is perhaps the most outstanding piece of sleight of hand that was ever invented... If you want to be slaves to the Bankers, and pay the costs of your own slavery, then let the Banks create money’

Lord Josiah Stamp, Former Director, Bank of England

Throughout history, people have always used coins made from precious metals e.g. gold and silver as a basis for storing wealth and facilitating trade. Modern banking replaced this traditional asset based system with paper based banknotes.

The origins of modern banking go back to the Goldsmiths of the 16th Century who stored gold on their premises for individuals who needed somewhere to safely deposit their wealth. Receipts were then issued to those who availed of this service. When the receipt was subsequently presented to the Goldsmith, the gold would be returned. As time went on the general public started to buy and sell using the paper receipts in place of actual gold pieces or coins. This paper based system relied heavily on the ability of the Goldsmiths to return the gold on demand and is the origin of the obligatory promise on each and every banknote stating ‘I promise to pay the bearer on demand the sum of X pounds’.

At this critical juncture, the Goldsmith’s discovered one of the greatest albeit unethical money making ideas of all time. The Goldsmith’s realised that people were not returning to them regularly for their gold and relying instead entirely on the receipts which were now being exchanged as legal tender. As long as the public had confidence in these receipts then they could be printed and issued without any corresponding increase in the amount of gold being deposited.

The market could then be flooded with these artificial receipts, which would be used as legal tender. This would allow huge loans to be forwarded to the general public, thereby earning the Goldsmiths interest. As time went on and their credibility was enhanced, the Goldsmiths realised that they needed to hold less and less gold in relation to receipts issued leading to the birth of the ‘fractional reserve system’.

Fractional reserve is therefore a deceptive system which allows an expansion in the supply of paper money without a corresponding rise in the assets held by the bank.

This new money is only available to society through taking an interest bearing loan from the bank, and has been the cornerstone of the Western economic system from the days of the Goldsmiths back in the 16th Century to the present day.

Consequently, the money that we own is not backed at all by real assets. It is simply and purely worth only the paper it is written on and is only deemed to have additional value because society has confidence in the economic system.
FACT

‘The richest 225 people own more wealth than the poorest 2.5 Billion’


“If the American people ever allow the banks to control the issuance of their currency, first by inflation then by deflation, the banks and corporations that will grow up around them will deprive the people of all property until their children will wake up homeless on the continent their fathers occupied. The issuing power of money should be taken from the banks and restored to Congress and the people to whom it belongs. I sincerely believe that banking institutions are more dangerous than standing armies.”

Thomas Jefferson, Former President of the United States

The governments and elites of the Western world clearly have a vested interest in ensuring society retains confidence in interest based banking. The biggest threat comes from inflation which over time devalues the worth of a currency and therefore undermines confidence in the system.

This effort to control inflation has been taken very seriously, with the development of an entire economic school of thought ‘Monetarism’. This ensures the supply of money is tightly regulated and does not lead to excessive price rises in times of economic growth. Conversely, control is loosened and banks encouraged to supply more money in times of depression as a mechanism designed to artificially boost growth. Central Banks all over the world have also been tasked with a delicate balancing act of raising central interest rates on the one hand to ensure inflation is kept under control and lowering interest rates on the other hand to prevent recession. This ‘boom & bust’ cycle has the following glaring faults:
Banks are given too much power

The ability to create money gives banks and other financial institutions incredible levels of power by permitting the creation of artificial wealth for which they have carried out no corresponding real economic activity. This elite have an unacceptable level of control over society’s well being. Abuse of this power takes many diverse forms but can perhaps best be understood by examining the impact of debt on the third world.

Economic growth is hindered

As money is permitted to attract a rate of return, banks are able to generate profits through interest. Banks will invariably prefer to lend to those who have the greatest collateral because they represent the lowest risk of default. Those who have the most viable business plans are not always those who have the greatest collateral. Consequently, interest based banking inhibits economic growth by failing to promote the best business ideas which, if supported would result in higher economic growth.

The rich get richer

Those with the most collateral are by definition the wealthiest in society. By giving these people preferential access to money, capitalism has a persistent tendency to favour the rich and discriminate against the poor, ensuring that the rich just keep getting richer, and the poor just keep getting poorer.
In 1944, the IMF & World Bank were created in order to provide developmental assistance for non-commercial projects and to ensure stability through assisting nations in short-term balance of payment difficulties.

In 1987, the Institute for African Alternatives (IAA) called for the dissolving of the IMF & The World Bank, largely on the grounds that they had done more harm than good to the developing world.

The IAA established that banks were happy to use future income streams stemming from the mineral wealth of developing countries as collateral for making massive but dubious loans to ruling cliques. Consequently, interest based financing resulted in banks being adequately insulated against default, but the developing countries were left impoverished. Empirical reports and analysis have revealed the following:

**FACT**
In 1989, The World Bank conducted a review of its policies and was unable to point to one single project which had improved the lives of the citizens in the country in question.

**FACT**
No country has ever paid off debt taken from the World Bank or private Banks.

**FACT**
The Debt imposed by the World Bank is not on the heads of individual leaders, but rather becomes a burden on the backs of ordinary citizens.

Consequently the reckless actions of a corrupt dictator will impoverish unborn future generations.

**FACT**
For many developing countries, interest repayments often constitute a greater % of GDP than Education, Healthcare and infrastructure combined.

**FACT**
The level of debt INCREASED by 61% from the 1980’s to the 1990’s. Living standards in Africa have stayed level or dropped during this period.

**FACT**
During 1982-90, developing countries paid £1.3Bn in interest & Capital to creditor countries.

**FACT**
The largest faith group in 3rd World are Muslims.

In essence loans forwarded to the developing world are not linked closely enough to specific developmental projects. They therefore constitute pure interest bearing debt, secured against what precious little natural resource these countries may have. Corrupt leaders have used loans to line their own pockets instead of improving their countries services. Populations have suffered as their mineral wealth has been used to service interest based debt instead of being used to provide essential services.

The above clearly demonstrates the failure of interest based financing to ensure societies overall well being.
Islam and Capitalism both agree that money is used as a store of wealth, and also as a means of exchange. However, Islam, unlike Capitalism does not view money as a commodity which can be bought and sold at a profit.

By denying money the role of a commodity, Islamic finance ensures the only way a financier can generate a profit is by purchasing an equity share in a business venture in exchange for his capital. This one difference strikes at the heart of the evils of interest based banking by ensuring money is better able to flow to those projects which are viable and away from those projects which offer the greatest collateral. This in turn enables economic growth rates to increase and the wealth generated to be shared more equally by society.

Islamic financing only permits the government to issue currency which must be backed by an underlying asset. This in turn, removes from private banks, control and power over the issuing of artificial paper money.

The origins of modern economic theory can be traced back centuries. In ‘Ihya Al-Uloom Ud-Deen’, Imam Ghazzali says the following about money;

‘The creation of dirhams and dinars are a blessing from Allah (SWT) as they have no intrinsic usufruct or utility. But there must be a basis of measure on which price can be determined as the exchanged commodities are neither of the same type nor the same size…. . Therefore all these commodities need a mediator to judge their exact value, hence Allah (SWT) has created dirhams and dinars’

Imam Ghazzali

Contemporary Shariah scholars have developed three modes of Islamic financing for use in today’s banking system.

It must be understood that the first two modes of Murabaha (cost plus pricing with deferred payment) and Ijara (leasing with buy back) do not have the capacity to cure the ills of interest based financing. This is because Murabaha and Ijara have been designed to operate within the interest based system. Murabaha & Ijara have reluctantly been approved by scholars on the basis that they:

‘may help one refrain from a glaring sin and save him from the evil fate of disobedience, which, in itself, is a cherished goal of a Muslim, though at an individual level. Moreover this may help society to advance gradually to the ideal target of establishing a total Islamic order.’

Justice Taqi Usmani

Our ideal target can only be achieved through the third mode of Musharaka; or equity financing. We now proceed to contrast Musharaka or equity financing with interest based financing.
Another way of illustrating this point would be to observe the working mechanics of a bank and its relationship with depositors and borrowers.

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<thead>
<tr>
<th>Interest Based Finance</th>
<th>Musharaka Finance</th>
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<tbody>
<tr>
<td><strong>Depositors</strong></td>
<td><strong>Investors</strong></td>
</tr>
<tr>
<td>Depositors provide banks with money</td>
<td>Investors share risk and return of business venture</td>
</tr>
<tr>
<td><strong>Interest Based Bank</strong></td>
<td><strong>Bank</strong></td>
</tr>
<tr>
<td>The bank pays the depositors the agreed rate of interest - normally 1-2% and keeps the rest</td>
<td>Borrower receives profits not interest from business venture</td>
</tr>
<tr>
<td><strong>Borrower</strong></td>
<td><strong>Musharaka Bank</strong></td>
</tr>
<tr>
<td>The borrower pays the bank the agreed rate of interest normally 6-7% and keeps the rest as profit</td>
<td>Bank purchases share in business venture</td>
</tr>
<tr>
<td><strong>Business Venture</strong></td>
<td><strong>Business Venture</strong></td>
</tr>
<tr>
<td>Borrowers invest this money to generate profit</td>
<td>Bank receives share of profit instead of interest from venture</td>
</tr>
<tr>
<td>100% of profits are received by borrower</td>
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The above demonstrates the need to merge the disciplines of investment and banking. Musharaka requires a change of mindset so that depositors are viewed as investors.
The illustration of Musharaka allows us to draw the following conclusions:

<table>
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<th>Risk and return must be shared between investor and borrower</th>
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<td>Musharaka only allows the investor to attract a return through purchasing a share in the business venture. As such, risk and return are shared between the borrower and the investor. Money is not deemed to be a commodity so cannot attract a rate of return in its own right.</td>
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<th>The bank is encouraged to identify the most profitable ventures</th>
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<td>The bank understands its profit is linked directly to the level of profit the business venture will generate, because it is denied an opportunity to earn a fixed rate of interest. The bank will therefore have greater incentive to seek out profitable ventures, instead of relying on those which offer greatest collateral.</td>
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<th>Economic power is retained by government</th>
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<td>By ensuring all paper currency is fully asset backed, private banks and financial elites are no longer able to manipulate the economic cycle. They are also unable to fraudulently amass huge amounts of wealth through the fractional reserve system.</td>
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<th>Greater wealth is generated</th>
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<td>More profitable business ventures will generate more profit for the bank and thus for individual investors. The borrower also benefits, as he has improved access to finance compared to interest based finance.</td>
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<th>Wealth is distributed more equally across society</th>
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<tr>
<td>By increasing returns to investors on the one hand and improving access to capital for borrowers on the other, the distribution of wealth across society is more equal.</td>
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Equity based finance is well established in the West, principally through investment vehicles like Venture Capital Funds. These vehicles operate as niche players as they tend to work with those who are unable to obtain loans from the bank. By refusing to treat money as a commodity, Islam compels banks to operate on an equity basis.

The single biggest challenge facing Islamic banking is to adopt Musharaka and move away from Ijarah and Murabaha.

In response to this state of affairs, 1st Ethical have launched a viable model of Musharaka equity finance.
The 1e Musharaka Fund supported by 1st Ethical

The following is an extract from the marketing brochure for the 1e ‘Musharaka Fund’. This fund represents a genuine attempt to introduce Musharaka equity based finance.

‘Musharaka’ is derived from the Arabic root verb ‘shirkah’ which means to ‘jointly participate’. It denotes the concept of a joint venture between two parties when entering into business. Musharaka lies at the heart of Islamic Financing philosophy, where the notion of sharing in risk and return between investors and entrepreneurs finds its natural home. Musharaka is a business venture which will attract capital from all individuals in society and employ it in nurturing the most lucrative business ideas. This pure equilibrium will be achieved by the intelligent attraction of capital and comprehensive due diligence. The net result will be interest-free financing for the best business ideas, whilst simultaneously enabling capital to generate extraordinary investment returns.

……..Interest based financing has never been able to equitably or efficiently allocate profit between the lender and borrower resulting in the persistent concentration of wealth in the hands of the few. When the principle incentive underpinning commercial financing changes from a guaranteed interest based return to become profit sharing then both the borrower and lender will prosper. Not just in absolute terms but also for each citizen relative to one another. Wealth distribution will be better balanced than under the current status quo. In addition, such a system would make far more efficient use of available capital thereby lifting productivity and profit for all. It is this ideal which via Musharaka we hope to emulate. As Lincoln famously said ‘money rightfully fulfils its role as a ‘medium of exchange’ and becomes the servant of all humanity, not the master’.

You can find out more about the 1e Musharaka Fund by logging on to www.musharaka.net or ringing 01204 559914
‘So lose not heart, Nor fall in despair,  
For you are bound to rise, If you are true in faith’  
Al-Quran 3:139

‘Actions are rewarded according to intention’. This powerful hadith, by linking reward to the intention instead of the success of a given action, allows the sincere amongst us to be winners tomorrow even if we fail in achieving our objectives today. The goal of replacing interest based finance requires us to travel along a challenging, difficult and unique path towards Musharaka. But we take every step knowing our Creator knows better than we do what is beneficial for us.

**This booklet has been our attempt to:**

- Explain the concept of interest, concluding that interest is *any amount repaid or received above the principal.*
- List the Qur’anic revelations relating to interest. We clarified that the ban on interest was revealed around 2AH, allowing sufficient time for the Prophet (SAW) to explain the concept to the Muslims.
- Explain the origins of money creation by the 16th century Goldsmiths and how these practices laid down the foundations for the modern-day fractional reserve system.
- Explain the shortcomings of interest based finance, especially with regards to 3rd world debt.
- Explain the Islamic view that money is a ‘medium of exchange’ and not a commodity which can be traded in its own right.
- Explain Murabaha and Ijara are not capable of achieving Islamic economic objectives. They can only by viewed as a stepping stone towards true Islamic finance.
- Present an Islamic solution to interest based financing through Musharaka equity finance.
- Demonstrate graphically that the disciplines of investment and banking need to merge in order for Musharaka to succeed.
- Introduce 1st Ethical’s Musharaka fund, which represents a first in achieving true Musharaka.

There are many well intentioned individuals who recognise the failures of Capitalism, especially its failure to distribute wealth fairly. We pray this booklet is a means of explaining how these failures can best be remedied and that it guides those who are beguiled by Capitalism onto the Straight Path. May the Almighty make us all a means of the revival and establishment of interest free financing. Ameen

**Sources**

There are a variety of sources we consulted in preparing this booklet. A full list is contained in the in-depth research paper written on this subject which can be found at www.1stethical.com/publications.
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