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The Nexus between Sharia Principles and Banking: Why Islamic Values Matter in Islamic Banking?

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Abstract
Purpose: This study aims to examine how Islamic principles and values serve as essential pillars in Islamic banking, distinguishing it from conventional practices. By analyzing the rationale behind prohibitions in Islamic banking, this research provides insights into their impact on stakeholders, clients, the Islamic banking industry, and society at large.
Research Methodology: This study uses qualitative library research to explore the integration of Shariah principle in Islamic banking. Primary Islamic texts and secondary scholarly sources are reviewed systematically, and inductive thematic analysis highlights the ethical rationale behind prohibitions on interest (*riba*) and unethical investments, underscoring Shariah adherence as a foundational framework in Islamic finance.
Results/Findings: Findings indicate that the adherence to Sharia principles within Islamic banks drives efficiency, risk protection, socio-economic benefits, such as wealth distribution, fair income distribution, sustainable growth, and social welfare. This provides a rational foundation for eliminating prohibited elements, emphasizing the broader social mission of Islamic banking.
Conclusion: This study underscores the critical role of Sharia principles in Islamic banking, particularly emphasizing the prohibitions against *riba*, excessive uncertainty, and highly speculative investment.
Limitations: This study focuses on the rationale behind prohibitions in Islamic banking broadly and does not empirically test the impact of each prohibition.
Contribution: The study contributes to the field by rationalizing the importance of Sharia values in banking practices, illustrating how these principles create an ethical banking system that fosters mutual benefit rather than exploitation. This insight adds a nuanced perspective on the socio-economic benefits of non-interest-based banking models, which prioritize fairness and community welfare.

Keywords: *Islamic Banking, Sharia Principles, Islamic values, Prohibited Elements, Islamic Finance.*

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1. Introduction

Islamic bank was established almost a half century ago, entering the mainstream financial services sector to provide banking solutions that adhere to *Shariah* principles which prohibits interest (*Riba*), speculative trading or investment (*Gharar*), and excessive risk taking in investment and financing (M. S. Khan, 1986; Rosly, 2008; Beck et al., 2013; Ariff et al., 2014; Lewis et al., 2014). These principles are included into the entire operation of an Islamic bank in order to ensure that fairness and justice are upheld when providing financial services. The main function of a bank is to link and facilitate between Surplus Fund Unit (SFU) and Deficit Fund Unit (DFU). This function encourages bank to develop financial product that can address financial need of society. As an initial intermediary institution, conventional bank provides a banking solution to solve this problem. Bank will borrow the money to their creditor (investors) and repay the principles plus interest which is agreed upon. To offset operation cost and the cost of money, the bank will lend certain amount of money to debtor and encourage them to payback the loan with interest. Exchanging money for money unequally is triggered issue of *riba* in Islamic perspective. Since the Islamic bank also categorized as intermediary institution, they must be free from this element (interest free banking) (Siti-Nabiha & Adib, 2020; Nawaz et al., 2021). Furthermore, In Islamic law, *gharar* refers to any transaction involving possible items whose existence or description are uncertain due to a lack of information and understanding about the contract's ultimate outcome or the type and quality of the contract's subject matter (Dusuki, 2011; Fatchurrohman & Saputri, 2022). Other than that, *gharar* also refer to excessive uncertainty and speculative action which is detrimental to other party. The issue of *gharar* in conventional banking practice arises when a bank invest the creditor's money to derivative product such as forward, option, and future contracts. For instance, during the Global Financial Crisis in 2008, it was revealed that many banks had substantial investment in credit derivatives and channel creditor's fund to risky mortgage-backed securities. Banks' involvement in these high-risk derivatives became a significant factor in the crisis, as they magnified losses beyond the capital reserves held. This practice of trading in derivatives for profit led to increased scrutiny, as such activities place creditors' funds at risk in the pursuit of speculative gains, making them vulnerable during financial downturns (Financial Stability Board, 2015). Indeed, these actions are prohibited in Islamic banking due to inherent excessive uncertainty and highly speculative and often linked to money game (gambling).

Islamic bank is strictly prohibited to use interest rate as proxy in banking business for making profit. Interest rate possessed element of *riba* in giving loan, against the principle of benevolence loan (*qarḍ hasan*) in *muamalat* (Ridwan et al., 2023). Charging loan with interest is considered as *riba al-qard* in Islamic financial transaction which resemble *jahiliyah* practice that condemned by *Qur'an* and *Sunnah* (M. S. Khan, 1986). Other than that, Islamic banking practice is not allowed engaged with speculative action and excessive uncertainty which trigger potential dispute among parties and expose to greater harm. Short-selling and interest-rate swaps are examples of transaction contains abovementioned elements that possibly influence volatility in financial market (Gomez et al., 2021). Islamic banking has emerged as a pivotal segment of the financial services industry, distinguished by its commitment to Shariah principles and ethical finance. However, while Islamic banking prohibits elements like *riba* (interest), *gharar* (excessive uncertainty), and *maysir* (speculation akin to gambling), the theoretical and practical reasons behind these prohibitions require more clarity. Studies highlight the need for Islamic banks to offer distinct financial products that uphold Shariah values while meeting the financial needs of modern stakeholders (Beck et al., 2013; Rosly, 2008; M. S. Khan, 1986). Addressing the rationale behind the prohibition of elements like *riba* and *gharar* could help Islamic financial institutions align their operations more closely with stakeholder expectations, enhance product differentiation, and reinforce stakeholder trust (Ariff et al., 2014; Lewis et al., 2014).

The gap in current research lies in a detailed, evidence-based understanding of the implications of avoiding *riba*, *gharar*, and *maysir* in Islamic banking. Most studies focus on either the principles of Shariah prohibitions in general terms or compare financial performance across conventional and Islamic banks (Nawaz et al., 2021; Siti-Nabiha & Adib, 2020). However, there is limited empirical research directly linking the absence of these prohibited elements with positive outcomes for stakeholders. The novelty of this study lies in examining how the exclusion of *riba*, *gharar*, and *maysir* can concretely impact Islamic banks and their stakeholders. This approach is essential in differentiating Islamic banks from their conventional counterparts not only by prohibiting certain practices but by demonstrating the positive social impacts of Shariah compliance on financial stability and stakeholder well-being.

2. Literature Review

2.1 Islamic Banking

A bank is an institution that gathers funds from the public through deposits and then allocates these funds back to the community in the form of credit or various financial products, aiming to enhance societal welfare (OJK, 2022). Intermediary is the core function of the bank to facilitate Surplus Fund Unit (SFU) and Deficit Fund Unit (DFU). Technically speaking, this function is the heart of banking industry to serve global communities meeting their financial need (Kettell, 2011). Banking system employ interest rate as parameter to determine how much money they will return to depositors and charge to customer's loan. Since the bank-interest is not allowed to implement in Islamic point of view due to the issue of *riba*, an alternative banking system emerged in the global landscape by introducing interest- free banking system. A new product has developed in industry which adhere to Islamic principles (Ahmed, 2014; Kettell, 2011; Lewis & Algaoud, 2001; M. S. Khan, 1986).

Islamic banking begun to emerge in the early 1970 when oil crisis occurred in 1973. Jeddah was a silent witness to the established of Islamic Development bank in 1975 as agency international aid agency which promoting interest-free basis. In the same period, the commercial bank was established in Dubai by opening Dubai Islamic bank, soon followed by Faisal Islamic Bank of Egypt and Kuwait Finance house in 1978. The Islamic bank (IB) was developed back then due to a renewed vitality of Islam in the middle of twentieth century created a strong demand for *sharia* compliant financial instrument (Martens, 2001). In addition, the tendency of Muslim communities comply with Sharia law had bring a wind of change for banking industry to establish sharia compliant intermediary institution to avoid interest which is deemed as impermissible instrument in Islam (Wilson, 2007). The objective of establishing Islamic bank as a new horizon replacing interest-free banking system is to negate the evil of *riba* that potentially contribute to a greater harm in society rather than benefit.

Moreover, Islamic bank was established with the goal of having a stronger impact on the socio-economic welfare of society. The commitments rely on the practice and operation of Islamic bank that adhere to Islamic values and *Shariah* principles in order to accomplish Islamic economic objectives including wealth distribution, promoting ethical values, social justice, and promoting economic development (Lewis & Algaoud, 2001; Dusuki, 2011). These objectives are crystally supposed to be served by Islamic banking industry to demonstrate that they are not similar to conevntional one, which places a premium on profit maximization and shareholders value creation rather than achieving social welfare for sustainable economic development. Given fact that, bank as intermediarry institution has played fundamental role to support economic development in society.

Table 1. Key differences between Conventional and Islamic Banking

Aspects	**Conventional Bank**	**Islamic Banks**
Principle	Based on secular principles	Based on Qur'an, Sunnah, and Islamic jurisprudence and law.
Objective	Profit and shareholders value maximization	Achieving *Shariah* objectives, socio-economic welfare, and profit
Activities	Must be legal	Must be *Shariah* compliant (i.e. no speculation, uncertainty (*gharar*), pork related, alcohol, gambling, prostitution, and other illicit industries)
Earning source	Interest rate	PLS, lease, margin from selling asset.
Status of money	Money is regarded as a commodity that may be exchanged and rented.	Money is considered as medium of exchange. Exchanging between them must be equal and in spot basis.
Wealth distribution	No instrument for income distribution	Paying *zakat* on income to ensure distribution of income

Commitment	Having a commitment to maximize shareholders value and profit	Having commitment to realize social welfare, justice, and equity. At the same time can generate profit.
Organization structure	Supervision by a central bank or other governmental agency	Supervision by central bank or other governmental agency and *Shariah* council/committee
Contract structure	Predetermined rate of interest or return	Promoting Profit and risk sharing of invested project
Accountability and Responsibility	Responsible to shareholders	Responsible to Allah Almighty, shareholders, and the wider community
Status of clients	The relationship of the bank with its client, is that creditors and debtors	The relationship of the Islamic bank with its client, is that investors, enterpreneur, buyers, and sellers
Late payement charges	Imposing penalty and compounded interest in case of defaulters. This fine will be deemed as income for banks	No provision to charge defaulters. Imposing *ta'wid*, a smal amount of compensation, for late payment and it goes to charity.
Evaluation	Concern for the creditworthiness of the client when giving loans	Concern for the project's viability when investing in a partnership

Sources: (Antonio, 2010; Bakar, 2010; Dusuki, 2011; Ariff et al., 2014; Ullah et al., 2014; Iqbal & Molyneux, 2016; Habib, 2018; Orhan, 2018; Zafar & Sulaiman, 2021)

From the table above it shown a crystal clear the difference between conventional and Islamic bank. The fundamental aspect rely on the principle, where conventional bank based on secular and capitalism principle while Islamic bank based on Qur'an and Sunnah as the main guidelines to operate. This foundation then defines how Islamic banking should operate, what activities are permitted and prohibited, how interest rates are forbidden in Islam, and how Islamic banking is able to address the most significant economic development concerns, namely wealth distribution, justice, and equity. So that, the sustainable development and social-wellbeing can be achieved.

2.2 Shariah Principles in Banking practice

Shariah is a term from Arabic language derived from "*shara'*" which means "path". Shariah in epistemology has a meaning of a set of provisions from Allah Almighty and his messengers, derived from Qur'an and Sunnah as guidance to follow by the rest of *mukallaf* (mature and intelligent) to acquire God pleasure. *Shariah* principles are applied not only for interaction between creator and creation (*hablu minallah*) but also for creation with creation (*habluminannas*) in *muamalah* activity. In banking practice, *shariah* principles are adopted by Islamic banking to ensure all activities completely removed from prohibited elements determined by *syara'*, which derived from Qur'an and Sunnah. Islamic banking practice must be free from using interest rate or *riba*, high certainty (*gharar*), gambling or money game (*maysir*), and free from all forbidden related business activity.

2.2.1 Free of Interest/Usury (Riba)

Usury practice in Islam is forbidden because there is unconscious or conscious addition from another party which is not fair in that situation. It means, there is another party that loses and another gain benefit for it. *Riba* is similar with the someone who tries to rob the money from other with wrong manner (*bathil*). Therefore, Allah Almighty forbid *riba* and allow *bai'* or trading, as can be seen in Qur'an Chapter two verse number 275. *Riba* in practice can arise in loans (*riba addayn*) and also emerge in trade (*riba' al-bai'*). *Riba al-bai'* consists of two types, first *riba* is caused by the exchange of similar items in which the amount of exchange is not balanced each other (*riba al-fadl*), secondly *riba* is caused by the time period in similar goods exchanged in which the amount is exaggerated (*riba nasi'ah*) (Dusuki, 2011).

2.2.2 No element of Uncertainty (Gharar)

Uncertainty or *Gharar* contain speculation for something. This practice also prohibited in Islamic finance, so any transactions entered into must be free from this element. Contracting parties should have complete knowledgeable about the product that will be revealed to anticipate exploitation in exchange (Alam et al., 2017). Each party is involved in the exchange must be clear what kind of contract used, what the product will be traded and its complete specification. In Islamic finance, these elements should be eliminated. Some of conventional financial products that contain a *gharar* in its contract is a derivative product such as forwards, futures, option, and short selling with speculation. Most of these products are prohibited under Islamic law because there is no certainty in that transactions. Elements of *gharar* includes high volatility and speculative investment with purpose to gain immediate profit. The speculative moves in banking practice can be seen when bank engage with derivative products for maintaining their liquidity or close the spread gap. Islamic bank is prohibited to engage with this kind of activity due to highly speculative and excessive uncertainty in nature which bring greater harm (*mafsadah*) (Ahmed, 2014; Dusuki, 2011).

2.2.3 Prohibition of Gambling or Money Game (Maysir)

Maysir is one of broadening gambling with the game of changes model. *Maysir* is the type of lucky-based income rather than profit, accumulated from careful consideration of the transactional risk involved (Kettell, 2011). The logical reason is why *sharia* law prohibits *maysir* is a type of income that comes from luck without involving the appropriate effort to get income, in other words, that effort does not involve more effort but gets an unexpected result. It can be argued that *maysir* in practice can make someone ease to the acquisition of wealth by chance. In addition, *maysir* is an effort in investment activities to correlate the level of investment rate with the real sector in order to increase aggregate supply. *Maysir* can be argued as an unproductive investment because it is not directly related to the real sector and does not have an impact on increasing the aggregate supply of goods and services. Because of this, gambling or *maysir* is prohibited in Islam (Dusuki, 2011; M. S. Khan, 1986).

2.2.4 Restricted to Engage with Illicit Industry

Banks provide a range of credit and services to meet the diverse needs of society, acting as essential facilitators of capital access, financing, and transaction services for individuals and businesses (Beck et al., 2013). Conventional banks, guided primarily by profitability metrics, engage in business activities by offering credit and transactional facilities to entities deemed creditworthy, including those in high-risk or controversial sectors, provided they demonstrate the capacity to repay both the principal and interest (M. F. Khan, 2010). In contrast, Islamic banks are explicitly prohibited from engaging in business with industries considered illicit (haram) under Islamic law, such as liquor, gambling, pornography, Shariah non-compliant food processing, and adult entertainment (Iqbal & Mirakhor, 2007). The criteria for prohibited industries in Islamic finance have been broadened to include entities with significant adverse impacts on society and the environment. This encompasses businesses with poor Environmental, Social, and Governance (ESG) ratings or associations with activities contributing to humanitarian crises (Nada & Ghozali, 2024; Ryngaert & Jaarsma, 2024; Kabir Hassan et al., 2021).

This restriction reflects the fundamental principle in Islamic finance that all transactions must comply with Shariah, or Islamic law, which mandates ethical, socially responsible investments (Chapra, 2000). Guided by the Qur'an and Sunnah, Islamic banks are required to thoroughly evaluate the nature of the businesses they support to ensure they do not involve or profit from prohibited (haram) activities. Instead, Islamic banks focus on sectors that are considered halal (permissible), such as real estate, healthcare, and manufacturing, where financing can support social welfare and economic development in line with Islamic values (Dusuki, 2008).

3. Research Methodology

This study employs a qualitative research approach, specifically through library research, to explore the internalization of Islamic banking principles and Shariah values within financial systems and practices.

Drawing on both primary and secondary data sources, the research aims to build a comprehensive understanding of the ethical and operational frameworks that distinguish Islamic banking. Primary data for this study is sourced from core Islamic texts, including the Qur'an and Sunnah, which establish the foundational principles governing Islamic finance. These texts provide the moral and ethical basis for prohibiting certain financial practices, such as interest-based transactions, and for promoting values like fairness, equity, and social responsibility within banking practices.

In addition to these primary sources, secondary data includes peer-reviewed research articles, authoritative books, and other reputable publications focused on Islamic finance, Shariah-compliant banking, and ethical financial practices. By collecting secondary data from reliable academic sources, the study broadens its perspective, incorporating contemporary insights and contextual understandings of Shariah principles. The data collection process follows systematic literature review techniques, a method commonly applied in qualitative Islamic finance studies. Through this approach, relevant academic and religious texts are identified, collected, and organized, with particular attention to extracting themes that elucidate Islamic banking principles and their application in modern finance.

Data analysis is conducted through an inductive process, using thematic analysis to identify recurring themes and patterns across the selected literature. This analytical approach allows for a deeper understanding of the logical framework behind Shariah prohibitions on specific financial elements, such as *riba* (interest) and investment in unethical industries, while also highlighting the rationale for integrating Shariah principles in banking. By synthesizing insights from primary religious texts and secondary academic sources, this study constructs a coherent rationale for the unique guidelines in Islamic banking. Ultimately, this approach emphasizes the importance of Shariah adherence, not only as a regulatory framework but as a moral imperative that underpins the ethical integrity and social impact of Islamic financial institutions.

4. Results and Discussions

4.1 Conventional bank and Islamic bank: comparison and business nature

In terms of serving financial customers through products and services, there are no substantial differences between conventional and Islamic banking. Conventional banks operate as profit-maximizing intermediaries with the objective of maximising shareholder value. Meanwhile, an Islamic bank transcends this. They are equipped with a set of religious ideals and principles, including ethical and jurisprudential concepts. Additionally, Islamic banks are founded to advance Islam's social-economic goals and to promote equality, justice, and social well-being in general. Without a doubt, Islamic banks have devised numerous instruments to meet the diverse needs of consumers in order to accomplish their goals. Moreover, what makes Islamic banking differed from conventional one? IBs do not use interest as the income stream, however, they use PLS and trade-related relations. Simply to say, IB will enter type of partnership, sale, and lease contract with customers in conducting financial services (Orhan, 2018; Zafar & Sulaiman, 2021). Even though Islamic bank is interest free banking, the criticms emerged in the area of financing contract used. Islamic bank seems heavily rely on debt-based financing such as *murabahah* (cost add profit) which has a fix rate across financing tenure rather than equity-based with PLS concept (Syafril, 2023). This model resembles interest-rate in terms of making money or profit without bearing any resposibility. Its violating concept "*gharm bil ghumni*" under Islamic legal maxim which requires bank involve in risk-sharing for generating the profit.

Another issue emerged is the reluctancy of Islamic bank engage with PLS financing product as ideal concept in islamic finance. The proportion of PLS product such as *musharakah* and *mudarabah* compared to debt-based financing (i.e murabahah) is found lower in Islamic banking product (Dani et al., 2024; Juliyanti & Wibowo, 2021). For instance, PLS financing remains relatively low among Indonesian Islamic banks, averaging around 11.91% of total financing from 2016 to 2020. Several factors contribute to this limited uptake (Fahamsyah & Hamdan'Ainulyaqin, 2023). A key reason is the complexity involved in PLS contracts, which require Islamic banks to have an in-depth understanding of clients' profiles, leading to more elaborate procedure. Additionally, PLS contracts incur high transaction costs due to the need for effective management and supervision by the banks (Louhichi & Boujelbene, 2016). These contracts also carry increased financing risks, stemming from institutional issues that create information asymmetry and moral hazard (Trilaksono et al., 2021; Beck et al., 2013). Nevertheless, PLS contracts are valued for their fairness, as they allocate profits and losses based on pre-established terms, potentially making Islamic banks more appealing to clients (Syafril, 2023).

4.2 Rationale behind prohibited elements in Islamic banking practice

The emergence of Islamic banking was predicated on adherence to *Shariah* rules and laws, which served as the primary justification for the shift away from the interest-based financial system. Therefore, Islamic bank engage in transactions such as sales, partnership-based contracts (*Musharakah and Mudharabah*), lease-based contracts (*Ijara*), and benevolence finance (*Qard hasan*), all of which must be backed by assets.

4.2.1 Prohibition of riba and contention of interest rate status in Islamic banking

Islamic banking is normative concept to describe the conduct of banking in accordance with *Shariah* principles and Islamic moral values. Under Islamic banking, money is deemed as the medium of exchange and a store of value which has no inherent value itself (Hassan & Aldayel, 1998). This point of view brings the interpretation of money as *ribawi* item according to the definition is given by *Qur'an* and Sunnah. Delayed or postponed completion of exchange also amount to *riba*, whether it follow or not by an increase in any of exchanged counter values. However, the status of interest rate in baking system whether its treated as *riba* or otherwise, sparked the debate among *Ulama* and Muslims scholars. There are three Jurist's position on the legal status of interest rate in banking: radical, pragmatic, and liberal approach.

The radical or idealist approached is adopted by classical *fiqh* jurist who treat interest rate as *riba* and consider it as sin that must be avoided. The classical scholars such as Syekh Taqi Usmani and Mawdudi from Pakistan are prominent scholars promote this view based on Qur'anic verse and Sunnah which demonstrate the prohibition of *riba* in *muamalah* transaction (Kamla & Alsoufi, 2015; Saeed, 2011). In short, the prohibition of *riba* in Islam is axiomatic and has no room to debate.
The *Qur'an* says:

O you who believe! Observe your duty to Allah, and give up what remains of your demands for usury, if you are (in truth) believers. And if you do not, then take notice of war (against you) from Allah and His Messenger. And if you repent then you have your capital (without interest). Deal not unjustly, nor be dealt with unjustly.

(Al-Baqarah:278-279)
And Prophet Muhammad (PBUH) explain more detail on *hadith* based on what *Qur'an* means by *riba*: *"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal and hand to hand, if the commodities differ, then you may sell as you wish provided that the exchange is hand to hand"* **(Sahih al-Muslim).**

According to this *hadith* there are two main criteria that bring the issue of *riba* in transaction. The first and foremost is due to deferment of the time of exchanged and secondly, the different amount or counter value in exchanging two similar *ribawi* item (medium of exchange's tool and commodities). However, in order to avoid *riba* being occurred in transaction, prophet Muhammad (PBUH) provide the solution for this matter. Firstly, the transaction must be hand to hand or spot basis. Secondly, the exchange between two similar commodities must be equal counter value. Meaning that, no additional or deduction took place on it.

Meanwhile, the pragmatic approach aims to bypass interest rates by engineering and innovating financial products through unconventional methods (Caeiro, 2004). The application of *hiyal* (legal stratagem) as way out (*makhārij*) in Islamic finance practice is a perfect example of this approach. For instance, Islamic bank in Malaysia use *tawarruq* (commodity Murabahah) for multiple products of financing event though majority of scholars against the application of *tawarruq munazzam* (organized *tawarruq*) in Islamic finance (Asni et al., 2023).

In contrast, the liberal approach deem interest rate application in banking system is not similar to pre-Islamic *riba* and is not inherently evil (Saeed, 2011; Caeiro, 2004). The argument relies on the fact that inability of Muslim scholars interprets the issue of interest rate with regard to the role of intermediary institution in modern economic system. The failure of developing economic rationale of *riba* has led to significant error and hinder the effort towards social equity and justice in financial system of Muslim world (Ebrahim, 2009). Therefore, this view has led contemporary scholars such as Fazlu Rahman and others argue that the prohibition of interest rate in the presence state would be a cardinal error (Rahman, 1964). The strict enforcement of an interest ban in today's economic environment has produced adverse effects on economies and societies within the Muslim world. These effects include higher credit costs for all, including entrepreneurs, as well as complex financial transactions that rely on various legal stratagems. Additionally, there is a lack of transparent discussion around commercial and financial matters in Muslim societies. This situation suggests that the prohibition of bank interest, as implemented by Islamic banks, may conflict with the overarching principles of the Qur'an and Sunnah, as it restricts these institutions from adequately addressing societal welfare (Kamla & Alsoufi, 2015).

The modern of Islamic banking practice today is dominated by pragmatic approach. This approach allows industry to develop a sale-based product with a mark-up indexed to LIBOR (London Interbank Offer rate), closely mirroring fixed-interest loan. To banks and their Shariah Supervisory Boards, these contracts are structured as non-interest-bearing transactions, rendering them permissible within their legal framework (Kamla & Alsoufi, 2015). Despite considerable criticism directed at contemporary Islamic banking practices, interest rates remain unequivocally excluded in adherence to the idealist and traditionalist approach that categorizes interest as *riba*. In this framework, *riba* arises when a bank extends a loan with interest or ties repayment to a future date. From an Islamic perspective, such practices are identified as *riba al-duyun* (interest on debt contracts) or *riba al-nasiah* (deferment or delay-based *riba*), both of which are fundamentally prohibited.

The ongoing debate over the role of interest rates within Islamic banking has sparked critical examination of the economic rationale behind *riba's* prohibition. The subsequent discussion will explore the potential benefits of excluding *riba* from Islamic banking practices, aiming to bridge the gap identified by scholars of the liberal approach regarding the economic justification for *riba*'s prohibition.

4.2.1.1 The rationale behind prohibition of interest (riba)

1) Promoting justice and mutual benefit
   The rationale for prohibiting *riba* in Islamic banking is straightforward, its necessary for promoting justice, fairness, and mutual benefit for both parties. Additionally, by eliminating interest rates Islamic banking may seal off the opportunity of exploiting a weaken party. Too much level of debt compound with interest may harm those entities who dealt with and lead them felt into debt-trap which is the primary contribution to financial crisis (i.e global financial crisis in 2008).
2) Reducing agency cost
   Another benefit from the prohibition of interest rate according to (Hassan & Aldayel, 1998) is, it can reduce agency costs resulting from the lender-borrower relationships. The lender has an incentive to monitor the performance of Islamic financial institutions. Due to the financial institution's profit-loss contract with the borrower, the institution has a motivation to examine the borrower's behavior. There will be no need to insure the financial institution against default in this instance.
3) More productive
   Adopting interest (*riba*) makes people to be slothful and heavily rely on easy money without working for it (Alam et al., 2017). A simple forward strategy in accumulating wealth through exploiting others and make them suffer. Other than that, charging interest on loan will hamper the development of the real sector. Productivity will stall as banks will only serve clients who are creditworthy and have collateral to mitigate the risk of non-performing loans. For those who lack of creditworthiness, such as micro and small businesses, banks are unable to provide working capital--despite the fact that they are numerous and thirsty for capital or even as the main contributor for economic growth, particularly in emerging countries. In short, by eliminating interest (*riba*) in

financial transaction, bank will help more productive sector be developed which ultimately contribute to economic growth and close the gap of income inequalities.

4) Promoting sustainable growth
   Because conventional banks are obligated to pay a predetermined rate to depositors, they are more concerned with the safe return of funds with defined interest rather than promoting growth. This commitment leads them to lend their money to well-established business entities that are in a position having financial stability and sufficient security to return principles with stipulated interest. As a result, small businesses with insufficient collateral cannot obtain finance. Increased income and wealth inequality are also a result of the oversupply of credit to well-established parties and its denial to a huge segment of the population.

4.2.2 Prohibition of uncertainty or ambiguities (gharar) and speculative motive

Another important element that should be vanished in Islamic financial transaction is *gharar*. Literally, *gharar* means uncertainty and hazard. Technically, according to Sheikh Wahbah al-Zuhaily, *gharar* is a contract that carries a risk for one of the parties that could result in the loss of his property (Al-Zuhayli, 2003).

Unlike prohibition of *riba* that can be found specifically in the Qur'an verse, *gharar* has no explicit verse and explanation on it. However, *Qur'an* was said about all of business transactions that cause injustice and harm to any of the parties are forbidden to do. Allah almighty said that in *Surah al-Nisa'* verse 29:

"O you who believe! Eat not your property among yourselves unjustly by falsehood and deception, except it be a trade amongst you, by mutual consent."

The word *al-batil* (unjustly) refers to all category of defective and illegal elements in commercial contracts, including *gharar* as a form of taking other property without a justified basis. On the other hand, prohibition of *gharar* can be found through Prophet Muhammad various *hadith*. One example of hadith that narrated by Abu Hurayrah state that Prophet Muhammad (PBUH) prohibited all sales of *gharar*. Finally, based on the evidence shown above, majority of jurists unanimously agreed upon on the ban of *gharar* in Islamic financial transactions and on the fact that existence of *gharar* may render a contract invalid.

Gharar can be classified under two broad headings based on the degree of uncertainty (Dusuki, 2011; Alam et al., 2017). First and foremost is *gharar fahish* or major level of uncertainty. This *gharar* can render the contract become null and void. Major *gharar* arise when the asset or commodity does not exist, cannot be delivered, not according to the specifications, or deferment period is unknown in the context of deferred sale. Next, is minor *gharar* or called *gharar yasir*. This is an unavoidable *gharar* due to the nature of the subject matter and, unless it results in significant harm to one of the parties, will not undermine the contract's validity.

In banking practice, *gharar* may occur when the bank, for instance, financing the house in legal dispute. The situation may cause a conflict in the future among parties due to uncertainty of house's ownership status. Moreover, it must be obvious who owns the land and building, as well as the building's size, diameter, location, and specs. Therefore, Islam emphasize on possessing assets and good at first place prior to selling it to avoid any upcoming dispute among parties in the future.

Additionally, *gharar* (excessive uncertainty) includes speculative motives, often evident when banks engage in derivative instruments to take positions purely for profit by capturing spread differences. However, certain scholars advocate for the conditional use of derivatives, not for speculative gain or profit-taking, but strictly to manage liquidity and ensure smooth Islamic banking operations (Zahan & S Kenett, 2012). To maintain Shariah compliance, derivative contracts must be adapted to align with Islamic principles, replacing conventional instruments with compliant structures—such as utilizing *salam* (forward sale) as an alternative to futures contracts. Understanding the rationale for prohibiting *gharar* and speculative motives in Islamic banking is crucial, as it underscores the adverse impact of these elements and highlights the benefits that arise from their elimination, reinforcing the ethical foundation of Islamic finance.

4.2.2 The rationale behind prohibition of uncertainty (gharar)

1) Avoiding Future Disputes
   One of the primary rationales behind the prohibition of *gharar* is to avoid future disputes between the parties involved in a contract. In Islamic finance, clarity and transparency are paramount. A contract with elements of *gharar,* where terms are ambiguous or uncertain, increases the likelihood of disagreements and conflicts in the future. These disputes can arise because one or both parties may have different interpretations of the contract's terms, leading to claims of unfairness or deception. For instance, if the subject matter of a sale is unclear, such as the quantity, quality, or exact nature of the goods being traded, one party might feel cheated if the reality does not meet their expectations. This not only creates tension between the contracting parties but also undermines the overall stability and trust within the financial system. By ensuring that everything is clear and specific from the outset, Islamic finance seeks to prevent such issues, fostering a more stable and trustworthy economic environment.
2) Preventing Information Asymmetry
   Another key rationale for prohibiting *gharar* is to prevent information asymmetry in financial transactions. Information asymmetry occurs when one party in a transaction possesses more or better information than the other. This imbalance can lead to unfair advantages, where the more informed party may exploit the lack of knowledge of the less informed party. In an economic context, information asymmetry often leads to market inefficiencies and can even cause market failure. For example, in a scenario where a seller has more information about the defects of a product than the buyer, the buyer may end up overpaying or purchasing something of lesser value than anticipated. Such outcomes are considered unjust and unethical in Islamic finance, as they violate the principles of fairness and mutual benefit that are central to Islamic economic principles. Moreover, information asymmetry can distort market prices and lead to a misallocation of resources, further destabilizing the market. In Islamic finance, all necessary information must be fully disclosed to all parties involved in a transaction. This transparency ensures that everyone has equal access to the information needed to make informed decisions, thereby promoting fairness and preventing exploitation.
3) Ensuring Ethical Conduct and Social Justice
   In addition to avoiding disputes and preventing information asymmetry, the prohibition of *gharar* also serves a broader purpose of ensuring ethical conduct and social justice in financial transactions. Islam places a strong emphasis on promoting justice and preventing harm in all aspects of life, including economic activities.
4) Minimization of Excessive Risk and Speculation
   Islamic finance seeks to avoid *gharar* (excessive uncertainty) and *maysir* (speculation), both of which are prevalent in many derivative instruments. Many derivatives, such as options and futures, inherently involve betting on future price movements, introducing substantial speculative risk. This is seen as undermining economic stability and creating potentially harmful market volatility, which contrasts with the Islamic objective of promoting real asset-backed transactions and economic security.
5) Focus on Real Economic Activity
   Derivatives often involve financial contracts disconnected from underlying real assets, creating a "layered" financial system that can amplify systemic risk. Islamic finance advocates for a direct connection to tangible assets to ensure that financial transactions contribute to real economic growth rather than merely generating profit from abstract financial engineering. By avoiding derivatives, Islamic banks focus on productive financing that supports real economic activities and benefits society.
6) Protection from Financial Crises
   The 2008 financial crisis highlighted the role that complex derivatives played in exacerbating global financial instability. Islamic banking aims to safeguard financial systems from similar crises by avoiding complex, high-risk financial products. Without the over-leveraging associated with

derivatives, Islamic banks typically maintain more resilient and risk-averse portfolios that align with the ethical principles of risk-sharing and equitable wealth distribution.

5. Conclusion

This study underscores the critical role of Sharia principles in Islamic banking, particularly emphasizing the prohibitions against *riba*, excessive uncertainty, and highly speculative investment. Findings reveal that adherence to these principles not only aligns with Islamic moral values but also promotes efficiency, risk protection, and socio-economic objectives like equitable income distribution and sustainable growth. By avoiding riba and speculative practices, Islamic banks provide a socially responsible financial model that supports economic stability and fair wealth distribution.

The study contributes to the field by rationalizing the importance of Sharia values in banking practices, illustrating how these principles create an ethical banking system that fosters mutual benefit rather than exploitation. This insight adds a nuanced perspective on the socio-economic benefits of non-interest-based banking models, which prioritize fairness and community welfare.

Limitation and Recommendations

This study is focused only on rationale behind eliminating prohibited elements in Islamic banking practice in general, without robust testing on the significant of removing each element in empirical study. For future research, we recommend focusing on the impact measurement of each Islamic financial products on economic development. Observing the significance of non-interest-based products in stimulating economic growth would provide a deeper understanding of Islamic banking's role in supporting real economic activities and mitigating financial risks.

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