Islamic Law and Financial Intermediaries A Historical Inquiry and a Future Outlook

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During the last two decades, a large number of new Islamic financial institutions have been established both within and outside the Muslim world. These institutions, of which the majority are private commercial banks, are claimed to operate on the Islamic financial principles. Many interest-based banks have also set up branches, called Islamic branches, which operate according to the Islamic financial principles. Some countries such as Iran, Pakistan and the Sudan have by law forced all their financial institutions – both domestic and foreign off-shore institutions – to convert to Islamic financial principles. The main issues which will be discussed at this seminar are:[1]

– Why establish Islamic financial institutions?

– What makes a financial institution Islamic?

– Can an Islamic financial institution maintain its identity in the long run?

Why Establish Islamic Financial Institutions?

The main reason for promoting and establishing financial institutions based on Islamic financial principles is the rejection of Western style financial institutions by some Muslims. A narrow explanation for the rejection of these institutions is that their operations are based on interest which is forbidden by Islam. A broader explanation is that Western-style financial institutions reflect Western economic principles rather than the socio-economic thought of Islam, where the economic behaviour of the Muslims and the objectives and practices of the Islamic economic institutions have to be imbued with the rules and norms of Islam, *Sharīʿa*.[2]

Modern Islamic financial institutions are claimed to derive their legitimacy from earlier Islamic financial institutions, and their frame-

[1] Some issues in this paper are treated in more detail in Kazarian (1993).

[2] For a description of the economic behaviour in Islam, see e.g., Naqvi (1981).

work is based on Islamic financial jurisprudence which developed during the earlier periods of Islam.[3] Therefore, some historical insight into the development of Islamic financial institutions can serve to establish what we know about earlier Islamic financial principles and institutions.

The development of Islamic financial institutions can be divided into five different periods: The formative period, the Islamisation period, the bureaucratisation period, the secularisation period, and, finally the reformative period.

The Formative Period

There is little information about the economic and financial conditions in Arabia before and during the emergence of Islam. Departing from the references about the mercantile practices, there are many indications that much of the trade took the form of barter exchange. Mercantile regulations and ethics were frequently expressed in terms of qualities of goods, and not in the form of currency or prices.[4] In the available records dealing with this time, the valuation of products was rarely mentioned in terms of currency, but rather in terms of other goods, or by the same object with different qualities. Furthermore, the spoils of war acquired during the Muslim conquest of Arabian regions were mentioned in kind, whereas those acquired from the regions controlled by Byzantium and the Sasanid, were virtually always expressed in currency.[5] The currencies in circulation among the Arabs were struck by either the Byzantine or the Sasanid regimes. Therefore, there are reasons to assume that the economy was characterised by a relatively low degree of monetisation, and by the absence of established financial institutions. Furthermore, the socio-economic structure of the Arabian Peninsula was less developed than that of the neighbouring societies of Byzantine and the Sasanid empire.

From the available literature, two main financial techniques are known as a means of financing economic activities: *ribā* ('interest'), and *muḍāraba* (profit-sharing arrangements). A borrower could obtain a loan and pay a predetermined fixed amount as a cost. Alternatively, the financier could share the profit acquired from the use of the loaned

[3] See, e.g., Ahmed *et al.* (1983), Khan (1987), Siddiqi (1983), and Chapra (1985).

[4] The regulation of trade during this period, as mentioned in early literature such as *Ḥadīth,* denoted mainly in terms of barter economy.

[5] See al-Balādhurī (1866), p. 81f.

funds with the lender according to a predetermined ratio. It is difficult to determine from the available literature which of these types of financing was the more common. After the birth of Islam *ribā*-transactions were forbidden. The reason for the prohibition of *ribā* has never been discussed by earlier Muslim jurisprudents, other than from a legal viewpoint.[6]

As the early Muslim community grew and became a political and economic power, the need for better economic organisations arose. The wars against the relatively rich tribes and cities brought a large inflow of wealth, especially in the form of currency.[7] This new situation necessitated the establishment of new economic institutions. The first known 'financial' institution established by a Muslim community was created about ten years after the death of the Prophet Muhammad by the second Caliph, ᶜUmar. This institution registered all the members of the Muslim community *(dīwān)* in order to facilitate the distribution of the conquered wealth, *ᶜatā'*. The common funds acquired from the conquered territories were kept in a so-called house of wealth, *bayt al-māl*, and managed by the leader of the community, the Caliph. In general, the whole sum of wealth was distributed immediately.[8]

The existence of the institution of *bayt al-māl* was irregular, depending on the inflow of conquered wealth. Thus, when no funds were available for distribution among the members of the Muslim community, the institution lay dormant, as it had no other function, and no remunerated officials had been appointed.

The establishment of *bayt al-māl* and the distribution of wealth among Muslims had an ideological and a military dimension. According to the new faith, all resources are considered to be gifts from Allāh to all human beings, and therefore should not be concentrated in a few hands but rather benefit all members of the community. It was the duty of the leader of the new community to ensure that every individual was guaran-

6 According to the modern Islamic references, the charging of interest during the pre-Islamic period caused great economic misery to people who borrowed in order to meet their essential needs. However such a statement lacks evidence in earlier literature, See Ahmad (1978). pp. 3-6.

7 For example, al-Balādhurī stated that the wealth of the Byzantine in Syria was an explicit and important argument used by the Caliph to attract various Arab tribes to carry out the holy war, *jihād*. See al-Balādhurī (1866), p. 107 and pp. 81ff. See also Abū ᶜUbayd, op. cit., p. 249f., no. 618; Abū Yūsuf (1886). p. 25; and al-Māwardī (1853), p. 344.

8 Abū ᶜUbayd (1935), pp. 248ff., no. 613 and 621.

teed a 'fair share' of the wealth.[9] Furthermore, the distribution of *ʿatā'* was aimed at attracting new believers. Both Arabs and non-Arab Muslims were immediately granted an equal share in the wealth. Finally, the distribution of *ʿatā'* also had a military objective. It stimulated the soldiers' zeal to continue the invasion. The soldiers became dependent upon there pay and were obliged to abandon all their earlier occupations such as trade and agriculture. This had the result that Muslim soldiers were permanently mobilized for defending the new conquered areas or/and for further raids.[10] It is important to mention that before the rise of Islam the Arab Peninsula lacked a permanent military institution.

The Islamisation Period

During the first century of Islam, the early Muslim rulers adopted the legal and administrative institutions of the conquered territories of Byzantium and the Sasanid empire. Consequently, they were also prone to adapt to local financial practices. Successively, however, the inherited economic institutions underwent a process of Islamisation, which included administrative, fiscal, and monetary reforms. The first major administrative reform towards Islamic norms was the replacement of virtually all important officials of the *dīwān* by Muslims, and the introduction of Arabic as the official language to supersede the local ones.[11]

The Muslims gave the existing system of taxes a religious character by levying different types of tax on different individuals depending upon their religious affiliations. In addition to the existing taxes, the Muslims introduced two new types which are mentioned in the Qur'ān: an alm-tax for Muslims, *zakāt* or *ṣadaqa,*[12] and a poll-tax, *jizya,* applied to non-Muslims, *ahl al-dhimma.*[13] In consistency with the *Sharīʿa,* Muslim jurists

[9] Ibn al-Ṭiqṭaqā (1895), p. 116.

[10] See Moosa (1965), p, 70.

[11] It was in Syria, in 82/703, that Arabic was introduced as the official language. See al-Balādhurī (1866), pp. 193 and 301f.

[12] This tax is considered as a religious obligation, *farḍ,* aimed at purifying the souls of the believers. See Aghnides (1916), Løkkegaard (1950), and al-Dūrī (1974).

[13] This tax was regarded as a punishment intended to disgrace non-believers. Irrespective of their economic situation, all non-Muslims had to pay this tax, except women, children, and old people. According to al-Māwardī, the term *jizya* is derived from *jazā,* which literally means punishment, al-Māwardī (1853), p. 246. However, the *jizya* was applied only for a short period on the newly converted Muslims. One major reason for converting to Islam was to escape the tax burden. Consequently tax revenue to the state decreased. See al-Māwardī (1853), pp. 350-5.

developed the features of the fiscal system in terms of detailed descriptions concerning the objective of various taxes, their levels and extensions, and beneficiaries. The fiscal system was value-oriented, which includes both quantitative and qualitative aspects. It sought to improve the socio-economic situation of the less wealthy members of the Muslim community. For this reason, the rate of the taxes was deterrnined *ex ante,* depending upon the results of the economie activities of the taxpayers; it was not a fixed rate determined in advance. The monetary system inherited by the Muslim conquerors consisted of gold coinage struck by the Byzantine Empire and silver coinage produced by the Sasanid Empire.[14] At this time, the Muslims produced new kinds of currencies. At first they were, to some extent, imitations of the existing Byzantine and Sasanid currencies. The new "Islamic" currencies were struck in different places in the Empire.[15] This meant that the *dīnār* and *dirham* came to meet different standards of fineness, imprint, and form due to different local minting practices.[16] However, an attempt was made to produce a standard of currency. From the available records, it is evident that the Caliph Hishām, *c.* 106/725, centralised the production of coins to this capital at Damascus.[17] A standard "Islamic currency" was struck, as a result of a consensus among Islamic legal scholars concerning the standard of fineness, form, and imprints. All private mints were forbidden.

A centralised financial system and the production of currency by a locally based regime gave the new community a socio-economic independence. Furthermore, it implied a higher degree of monetisation, which should have a positive impact on the economy.[18] There are many statements in earlier literature indicating that the economic standard improved, and that several towns and trade centres experienced an economic growth.[19]

The prohibition of interest, *ribā,* obliged the new community to develop financial instruments based on a profit and loss sharing princi-

[14] See al-Balādhurī, op. cit., p. 465.

[15] Ibid., p. 468.

[16] Ibid., pp. 469-72.

[17] Ibid., p. 467.

[18] Prior to this period, the production of currencies was limited to the capitals of the Byzantine and Sasanid Empires. See Ehrenkreutz (1970), pp. 38f.

[19] See the references given by Hini, (1937), pp. 221-26.

ple. The two financial instruments – *muḍāraba* and *musharāka* – were modified to carry out the economic activities of the new society.

It seems that during this stage a pragmatic solution was achieved, where both the economic and the religious requirements of the 'good community' were fulfilled. The fiscal/financial instruments reflected the Islamic ethos, where *ribā* is prohibited, and simultaneously included driving forces such as the profit incentive for carrying out economic activities.[20]

The Bureaucratisation Period

From being a temporary store for conquered wealth awaiting immediate distribution among the Muslims, the institution of *bayt al-māl* became a permanently centralised institution. It attained its highest development during the period 833-892 A.D. (218-279 A.H.), when the political and economic administration was charactensed by a high degree of centralisation.[21] However, as early as the end of the second century after the rise of Islam, the budget of the state was characterised by chronic deficits due mainly to:

– a) the lower inflow of wealth from the conquered areas,

– b) the increase in military expenditures due to numerous rebellions, and

– c) the growth of the bureaucracy.

In order to finance the growing expenses, the public authorities were obliged systematically to break the Islamic financial injunctions, developed during the formative period of Islam.

The budgetary policy of fitting expenditure to income was abandoned. Fiscal policy was instead tied to a planned, regulated budgetary system based on an annual term.[22] The increase in the budget deficit made financial instruments based on a profit and loss sharing principle insufficient and inconvenient for raising funds to finance the activities of the state. For example, it was impossible accurately to determine the rate of return on the borrowed funds as a share ratio, since the capital was not used for commercial pursuits, but rather for state activities which did not generate any pecuniary profit. Consequently, new financial policies were

[20] For more details, see the comprehensive work of Udovitch (1970).

[21] See, e.g., the various text of Hilāl al-Ṣābī (1904), pp. 257-61. *Cf.* Løkkegaard (1950), p. 178f.

[22] Mez (1937), p. 107f., and Shimizu (1966), pp. 21.

introduced by the "civic regimes". Two financial techniques, which were based on an annual predetermined, fixed rate of return, were used:

– a) taking loans against interest, by issuing paper money in the form of goverment bills and letters of credit, *sakk* and *suftaja,* and

– b) the sale of rights to collect taxes from certain regions, *ḍamān,* to private bankers and higher officials.[23]

The central *bayt al-māl* sold the letters of credit to the bankers of the Court, *jahābidhat al-ḥaḍra,* at lower prices than their face values.[24] The state also borrowed from private bankers and merchants. The loans were based on annually predetermined fixed costs. Hilāl al-Ṣābī asserts that the state took loans from its Jewish bankers of the Court for a duration of 13 years at an annual rate of interest of 30 percent. It is also reported that annual interest rates as high as 80 percent were not unusual.[25]

The 'Islamic state' may be considered as the main factor contributing to the development of private financial intermediaries. The increasing expenditure obliged the state to look for new financing methods. Earlier, the Court had its own private bankers who supplied funds. The demand for funds increased and private bankers were consequently urged to turn to the public in search of loans, which where based on an annual fixed rate of return. This did not, however, hinder the state from inviting money changers, merchants, and landowners to offer funds on competitive terms. The latter became more frequent as a result of the increasing expenditures of the state.

Furthermore, the state contributed to the development of private financial intermediaries by confiscating private wealth. The Muslim rulers, who often lacked religious and political legitimacy, frequently used confiscation as a political instrument. Secondly, the rulers and their armies were not from the local population, as was the case in Egypt and the Levant. Opponents of, and revolts against the central power were punished by confiscation of wealth. In order to avoid the loss of their assets to the state, savers were forced to find safe means of holding their wealth.

According to Arabic sources, the private bankers were mainly the

[23] See Miskawaihi (1920), vol. 1, p. 320; and al-Ṣābī (1904), p. 81.

[24] See Fischel (1937), p. 9f.

[25] Miskawaihi mentioned that a *dirham* was paid as a cost for each borrowed *dīnār* for a period of one month. During this period, the value of one *dīnār* was 15 *dirham.* See Miskawaihi (1920), vol. 1, p. 326 and p. 213. See also al-Ṣābī (1904), p. 81f.

clerks of *bayt al-māl.* They were, however, easily identified by the authorities, who would search their offices in case of confiscation. Therefore, savers were always looking for anonymous bankers. At the beginning of the ninth century, merchants established themselves as a new category of bankers, and their stores acted as financial institutions. These institutions offered the possibility to exchange different currencies, deposit money, transfer money from one place to another, and take loans. They developed advanced financial techniques such as depository accounts, *waḍīᶜa,* letters of credit, *suftaja,* letters of exchange, *ḥawāla,* and bills of order or cheques, *sakk.* These financial instruments had a fixed period and were based on interest. There was a consensus between the state and the bankers of the Court concerning the rate of the interest. If the bankers charged an excessively high rate of interest, the state could force them to lower it.[26]

The economic order during this period was characterised by the introduction of a feudal military system into the Middle East by the Ayyubid-Mamluk regime.[27] Thus the political and economic policies were predominantly determined by the political law, *siyāsa,* based on military and feudal principles, rather than by the Islamic Sacred Law, *Sharīᶜa.*

An important fiscal feature of the feudal system was the increase of the use of a predetermined fixed land tax imposed annually on the farmers. This tax system, called *iltizām,* prescribed that a "lord", *multazim,* appointed by the central authority should be responsible for a district or a village, collect taxes among peasants, pay annual fixed tax to a public department, *dīwān al-iqṭāᶜ al-mufrad,* and keep the remainder, *fāᶜiḍ,* for himself. The peasants were serfs under their lords and attached to the village, which they could not leave without permission.[28] The taxes levied by the lords were very high.[29] Historically speaking, this new economic order was an innovation in the societies of the Middle East. From an Islamic legal viewpoint, this new fiscal system, based entirely on a predetermined annual rate independent of the result of the harvest, contravened the Islamic injunctions of a 'just' taxation policy.

[26] Al-Tanūkhī (1922). vol. I, pp. 201-4.

[27] For more details concerning the feudal system in the Middle East, see Poliak (1939).

[28] See the references given by Poliak, ibid., p. 65.

[29] Poliak stated that "toward the end of eighteenth century the Syrian peasants usually paid 12- 30 percent as annual interest." ibid., p. 68f.

During the reign of the Mamluks and particularly in the fifteenth century, the monetary system was characterised by a shortage of silver and the emergence of copper as a means of payment. Copper coinage was current during the earlier period, but used mainly by the poor. The reasons for the shortage of silver, given by the historians, were mainly that the goldmines in the Sudan dried up, and that silver was shipped to the West in exchange for copper.[30] The copper coinage successively replaced the silver, and hence became the main currency in which all commodities were accounted.[31]

The shortage of silver currency and the predominanee of the copper coinage as means of payment indicated that the economy was deteriorating. According to al Maqrīzī, the shift from silver to copper caused a substantial decline of the economic standard of all social classes of Egypt.[32] The shift of the economy from gold and silver to copper coinage contradicted the Islamic monetary principles. According to the Islamic law, all social and economic contracts had to be denoted by either gold or silver coinage, as this was the practice at the time of the Prophet.

As a result of the fragmentation of the Islamic Empire into various autonomous regions and independent states, the management of the public finance was decentralised and each provincial *bayt al-māl* became independent. In the earlier stages, funds could be mobilized from any of several different regions. The state took loans from private bankers and traders, and these lenders could be paid in the future against bills and promissory notes by the local *bayt al-māl,* where the funds had been invested. With the dissolution of the Islamic Empire, government bills and promissory notes from different regions became less acceptable, as the new states were characterised by different religious affiliations and politics. Furthermore, the political instability which characterised this period made the acceptance of paper money very risky, as the new regime would not necessarily accept the obligations of the previous one. Therefore, there is a reason to assume that the handling of money papers was relatively limited compared with the previous period.

With the defeat of the Mamluk regime by the Ottomans, the political and economic hegemony was transferred to Constantinople. Subsequently, the Arab regions in the Middle East became provinces of the

30 See the references in Shoshan (1982), p. 102.

31 Al-Maqrīzī (1957), p. 73f.

32 Ibid., p. 81ff.

Ottoman Empire. However, the fiscal and financial policies remained unchanged at the beginning of this regime. An annual fixed amount of tax was to be paid to the Imperial treasury by the lords, who in turn could make a profit by collecting a higher rate from the peasants.[33] The main difference was that the surplus of tax revenues was transferred to the capital of the Empire, Constantinople.

However, it should be noted that at the beginning of virtually every new regime or dynasty, all financial activities which contravened Islamic principles were forbidden, and financial agents, often non-Muslims, were punished. This policy, adopted by almost all regimes, was one measure among many in a process which aimed to give them legitimacy.

The Secularisation Period

The French expedition to Egypt in 1798 may be considered as the beginning of a new fiscal/financial era in the Middle East, characterised by the establishment of modern Western-inspired financial institutions. In virtually all countries, the existing legal systems were reformed by modernist Muslim scholars, who added new Western-influenced legal codes.[34] This facilitated the establishment of many central, national, and private banks, and the introduction of new financial methods and operations based entirely on interest. At the beginning of the nineteenth century, modern banking was introduced to the Western part of the Ottoman Empire. Compared with the previous period, the state not only took interest-based loans, but also provided loans based on interest. New private financial institutions, which were Western-influenced and operated on interest, were also established, first by foreigners and then by indigenous bankers. Some of the earlier private financial institutions which offered loans based on interest were transformed into new, modern, financial institutions, called *maṣrif* or bank, while others retained their structure and, thus, came to belong to the informal financial market. Some institutions, which were mainly owned by non-Muslims – Jews, Greeks and Armenians – even disappeared from the market completely after the Second World War after a process of confiscation and nationalisation.

The practice of taking and offering loans against interest became an

[33] Shaw (1962), p. 22.

[34] See, e.g., Adams (1933).

accepted natural feature in many official records and documents produced by officially appointed judges with religious authority. Interest received a religious legitimacy as many high ranking Muslim jurisprudents and theologians, *muftī,* formulated legal precedents, *fatāwā,* permitting the advance of loans based on interest. However, the acceptance of interest as a basis for financial transactions by many legal scholars of a high religious standing did not mean that the problem of interest associated with banking activities had been solved in the Muslim world.

The 'Reformative' Period

The disparity between Islamic theories, developed by Muslim jurisprudents, and the practices of the state throughout Islamic history was due mainly to the rigidity of the former in facing the economic requirements of that time. The taxes developed during the earlier period were not intended to finance increased military expenditure and the expansion of the bureaucracy. The only ideological basis for these taxes was to transfer funds from the well-to-do to the less wealthy members of the Muslim community. The financial instruments based on a profit and loss sharing principle also proved to be inconvenient for financing public activities. These instruments were developed for financing short-term trade activities, where profits could be calculated.

The reason for the rigidity of Islamic financial theories was the inability of Muslim legal scholars to develop these theories further in order to create new financial instruments. This inability was not confined to the field of financial transactions, *muᶜāmalāt,* but also impeded other personal and religious activities, *ᶜibādāt.* It has been argued that a consensus was reached among leading jurisprudents to close the door of independent reasoning, *ijtihād,* to search for new legal rules for solving new problems.[35] This means that new problems had to be solved by copying solutions which were recognised by earlier traditional jurisprudents. In this sense, the new financial situation of the state, in terms of a budget deficit, was not recognised by the earlier traditional jurisprudents, and therefore no new solution could be advanced by the contemporary jurisprudents.

After the Second World War many Muslims advocated the reopening

[35] See Schacht (1964), pp. 69-75.

of the gate of *ijtihād* in order to save the Muslim community from stagnation. In the financial context, a tacit consensus has been reached among highly ranked Muslim jurisprudents, theologians and some economists that Islamic financial theories have to be developed in order to meet contemporary economic requirements, and that these principles should function as alternatives to the modern Western financial techniques. An experimental financial institution based on Islamic financial principles was established in Pakistan in the late 1950s with succes.[36] The first phase of establishing modern Islamic financial institutions was, however, initiated by members of the Saudi and Kuwait royal families.[37] This coincided with a steep rise in wealth in the Gulf countries due to higher oil prices. With respect to historical evidence, the main question to be posed in this context is whether the establishment of Islamic financial institutions by these regimes has to be considered as a measure aimed to give legitimacy to their wealth increase or whether the increase of wealth was a precondition to carry out such an expensive and risky experiment.

What Makes a Financial Institution Islamic?

The establishment of Islamic financial institutions is regarded by the majority of Muslim scholars as an integral part of a complete Islamic economic system. This system is claimed to be a unique system, which differs from both the capitalist and the socialist system. Regardless of whether this system is peculiar or similar to the capitalist or socialist economic system, there is a consensus that the economic behaviour of the Muslims and the objectives and practices of the Islamic economic institutions have to be imbued with the rules and norms of Islam, *Sharīʿa*.

In order to conform with the Islamic financial principles, an institution has to fulfil a number of requirements which are developed by authors selected from among the highest ranked theologians and economists in the Muslim world. Many of them occupy high positions in

[36] See Qureshi (1974), pp. 187-206.

[37] The majority of Islamic banks are promoted or owned by two financial groups. The first one is Dār al-Māl al-Islāmī, and its major owner is Prince Mohammed al-Faisal al-Saud. son of the late King Faisal of Saudi Arabia. The second institution is Al-Barak International, which was founded by Shaykh Saleh Abdulla Kamel.

religious and economic institutions.[38] The Islamic requirements are given in the *Handbook of Islamic Banking* (HIB), *al-Mawsūʿa al-ʿIlmīya wal-ʿAmalīya lil-Bunūk al-Islamīya.* The HIB serves also as a basis for the organisation and operation of Islamic banks. The HIB is published by the *International Association for Islamic Banks* (IAIB). The IAIB has observer status at the Organisation of Islamic Conference and is recognised by the 50 member states. This means that the HIB reflects the opinions of the majority of the established Muslim elites, belonging to the Sunni sect of Islam. The most important requirements or principles which determine the religious identity of a financial institution are:

– a) the absence of interest-based financial transactions, *ribā* transactions,

– b) the avoidance of economic activities involving speculation,

– c) the discouragement of the production of goods and services which contradict the value-pattern of Islam, and

– d) the introduction of the Islamie tax, *zakāt.*

The Elimination of Interest, Ribā

Based on various verses in the Qur'ān, there is a consensus among Muslim jurisprudents and theologians that *ribā* is prohibited by Islam. The term *ribā* appears four times in the Qur'ān;[39] its literal meaning is growth, rise, swell, increase, and addition.[40] However, the technical interpretation of *ribā* is a controversial matter among Muslim jurisprudents and scholars. The main controversy revolves around the question of whether Islam prohibits usury or interest, or whether it prohibits the charging and payment of both. According to a pragmatic view, the Qur'ān prohibits the usury prevailing during the pre-Islamic era, but not the interest of the modern financial system.[41] This argument is based on a Qur'ānic verse, which prohibits the redoubling of the loan through an usurious process. The Qur'ān states:

[38] A large number of the Muslim jurisprudents or theologians have occupied the post of the Grand Mufti in their countries, such as Jad Al-Haqq Muhammad Khātir, ʿAbd Al-ʿAzīz E.Bāz, and Muhammad Al-Ḥarakān. The HIB is financed by the Prince Muhammad Al-Faisal Al-Saud, son of the late King Faisal of Saudi Arabia. See the Introduction of the HIB (1982).

[39] Quran, 2:274-80, 3:130, 4:161, and 30:39 (The figures to the left of the column denote the number of the sura and those to the right the number of the verse).

[40] See al-Jāzirī (1986), p. 215.

[41] For a comprehensive analysis of this view, see Rahman F. (1964), pp. 1 -13.

> "O ye who believe! Devour not usury, doubling and quadrupling. Observe your duty to Allāh, that may be successfull".[42]

Furthermore, as a reflection on the literature of the Tradition, *ḥadīth,* the pragmatic view argues that there is no firm evidence that the *ribā* prohibited by Islam is the interest of the modern financial system. The reports on the *ribā* in the literature of the Tradition are considered to be ambivalent and inconsistent. As Fazlur Rahman points out:

> ...the contradictions and inconsistencies in the riba-hadith and the evolutionary trend in this literature leading to an ever-increasing rigidity vitiate its authenticity and authority.[43]

Thus, according to the pragmatic view, transactions based on interest are regarded as legitimate, and interest becomes legally prohibited when the sum which is added to the loanable funds is exorbitant, and thereby used by the lenders to exploit the borrowers.

Contrary to the pragmatic view, the conservative view implies that *ribā* should be translated as interest and usury. It is argued that this interpretation is supported by the Qur'ān as well as by the Tradition. Any predetermined fixed positive return on the loan as a reward for the delay is defined as *ribā* and hence forbidden by Islam.[44]

According to the strict interpretation of *ribā*, the taking and paying of interest is forbidden by Islam regardless of whether the rate of interest is high or low, regardless of whether the funds will be used for production or consumption, and regardless of whether the loan is taken by a private borrower or by the government. The charging of *ribā* is prohibited in both the Qur'ān and the Tradition, while the paying of *interest* is forbidden only in the Tradition. Many orthodox legal scholars refuse to give any intellectual argument to support this Islamic injunction. As stated by one scholar:

> When the Creator... himself has forbidden something, this should be the greatest intellectual argument in support of it.[45]

[42] Quran, 3:130.

[43] Rahman F. (1964), p. 41.

[44] This form of *ribā* is called *ribā al-nasī'a.* Al-Jāzirī (1986), vol. 3, pp. 245-50. See Saleh (1986), pp. 13-8.

[45] See Manazir A. Gilani in Qureshi (1967), p. xix.

Recently, some Muslim scholars with an educational background in economics have, however, offered a number of socio-economic arguments as a reason for the prohibition of interest.[46] The most important, is that interest has a tendency to concentrate wealth in the hands of a few, and is condemned by Islam. Furthermore, the supplier of capital on an interest basis is not subject to the uncertainty facing the borrower. Such a contract is considered as unjust, and will lead to selfishness, which contravenes the Islamic injunction of brotherhood. Another argument for the prohibition of interest is that in the Islamic economics framework, 'capital as a separate factor of production does not exist, but is a part of another factor of production, namely enterprise.'[47] This implies that profiteering from the supply of capital without any personal commitment or exposure to financial risk is discouraged by Islam.

The Avoidance of Speculative Transactions, Gharar

Another feature condemned by Islam is economic transactions involving elements of speculation.[48] Speculative business like buying goods or shares at low prices and selling them for higher prices in the future is considered to be illicit.[49] Similarly, if future prices are expected to be lower than the present ones, an immediate sale in order to avoid a loss in the future is condemned.[50] The argument given for such a ban is that speculators promote their private gains at the expense of society at large by creating an artificial scarcity of goods and commodities, which results in inflationary pressures in the economy.

In general, Islam condemns the sale of goods and shares which are not in the possession of the trader.[51] Following strict interpretation of the *Sharīᶜa,* it is unlawful to sell against advance payment for future delivery. However, as an exception to a general rule, in order to serve the public needs of the Muslims, some legal schools allow such contracts to be applied to goods but not to transactions of currencies, *bayᶜ salam.*[52] Trade activities in the stock exchange markets are a controversial issue among

46 See Qureshi op. cit., al-Mawudūdī (1961), al-Ṣadr (1968), Siddiqi (1983), and Chapra (1985).

47 Uzair (1980), p. 38f.

48 For the definution of this term, see Saleh (1986), Chapter 3.

49 HIB (1982), vol. 5, p. 427. See also Mannan (1986). p. 289f.

50 Mannan (1986), p. 289.

51 HIB (1982), vol. 5, pp. 402-9. See also Saleh (1986), pp. 71-6.

52 HIB (1982), vol. 5, p. 335, and pp. 430-32.

Muslim scholars. Some scholars advocate the prohibition of spot transactions as well as derivative transactions,[53] while according to the HIB transactions taking place in the spot market are permitted, but not in the derivate markets (futures, forwards and options).[54] Moreover, the purchasing of shares or commodities for short periods solely to make a pecuniary profit is not allowed.[55] It has to be a long-term participation which aims to promote investments. Any financial transaction undertaken by an Islamic financial institution must be related to real production.

Financing Business Activities permitted by Islam

It is forbidden for an Islamic financial institution to finance activities or items forbidden in Islam, *ḥaram,* such as trade in alcoholic beverages and pork.[56] Furthermore, as the fulfilment of material needs assures a religious freedom for Muslims, Islamic financial institutions are required to give priority to the production of essential goods which satisfy the needs of the majority of the Muslims. The participation in the production and marketing of luxury activities, *isrāf waṭaraf,* is considered as illicit from a religious viewpoint.[57] The production and marketing of luxury goods is only encouraged when Muslim societies do not suffer from a lack of essential goods and services such as food, clothing, shelter, health, and education.

The Introduction of the Islamic Tax, Zakāt

Many Muslim scholars emphasise that fiscal policy has to evolve from the ideological framework of Islam.[58] It cannot be value-neutral and has to be integrated within all Islamic economic institutions. The fiscal policy will be based on the Islamic tax, *zakāt.* Consequently, every Islamic financial institution has to establish a *zakāt* fund for collecting the tax and distributing it exclusively to the poor directly or through other religious institutions. This tax is imposed on the initial capital of the institution, on the reserves, and on the profits.[59] It is also collected from the profit of

[53] See, M. Amini quoted in Siddiqi (1981), p. 241, and Mannan (1986), p. 289.

[54] HIB (1982), vol. 5, pp. 429-34.

[55] Ibid., p. 427.

[56] See Ahmed *et al.,* (1983), p. 260.

[57] HIB (1982), voh 6, p. 293.

[58] See al-Mawdūdī (1985), pp. 12-15.

[59] HIB (1986), the section of *Muḥāsabat al-Zakāt,* vol. 3, pp. 19-24.

the projects which are established or financed by the institution. At the discretion of the depositors, an Islamic bank has the right to collect *zakāt* from the returns paid on the deposits. However, it should be mentioned that a minority of Muslim scholars argue that the collection of *zakāt* is not the task of financial institutions but rather that of public welfare institutions.[60]

Socio-Economic Objectives

Some Muslims argue that the identity of an Islamic financial institution is determined not only by the above-mentioned principles. An Islamic institution has to operate according to the spirit of Islam. In this sense, the primary goal of an Islamic financial institution is not to maximise the profit as a Western-style institution does, but rather to render socio-economic benefits to the Muslims.[61] It should participate actively in the process of economic and social development of the Islamic countries within the framework of Islamic rules and norms, *Sharīʿa*. In other words, an Islamic financial institution has to combine both profit maximisation and the simultaneous achievement of socio-economic objectives. These objectives are (a) to increase the economic welfare of the Muslims, and (b) to arrive at a balanced economic development, characterised by social justice and an equitable distribution of income and wealth.

On the other hand, Muslim bankers and a minority of Muslim economists try to enforce a distinction between the *identity* of an Islamic financial institution and its *role*. The identity of this institution, which is called *ḥalāl institution,* is determined by the requirements mentioned above. A *ḥalāl* institution need not have a socio-economic responsibility but must rather maximise the wealth of the owners.[62]

The two examples, mentioned above, seek to illustrate the controversial opinions among Muslim scholars concerning the identity and the role of Islamic financial institutions in the economy.

Operational Basis of an Islamic Financial Institution

From an ideological point of view, the operation of any Islamic financial institution has to be based on trust finance, *muḍāraba*. The rules and conditions of the *muḍāraba* contract, which have their roots in the

[60] Ismail (1986), p. 2.

[61] HIB, (1982), vol . 5, pp. 153-5.

[62] See Khan and Mirakhor (1987), pp. 1-6.

Middle Ages, vary from one Islamic school of law to another.[63] In general terms, a *muḍāraba* is defined as a contract between at least two parties, whereby the one, the financier *(sāḥib al-māl),* entrusts funds to the other, the entrepreneur *(muḍārib),* to undertake an activity. The entrepreneur returns the principal to the financier with a predetermined share of profit. In the case of a negative profit, the financier loses some or all of his capital, and the entrepreneur does not receive any remuneration for his labour and effort. The financial positions of both the financier and the entrepreneur have to be exposed to a risk, *mukhāṭara.*

Contemporary Muslim jurisprudents and economists have modified and combined the different rules of this contract to a convenient synthesis for the purposes of modern financial activities. The new concept of *muḍāraba* can be considcred as a mixture of different definitions provided by various Islamic schools of law. In an Islamic bank, for example, the *muḍāraba* contract has been extended to include three parties: the financiers, the financial intermediary, and the users of funds. An Islamic bank acts as an entrepreneur when it receives funds from depositors, and as a financier when it delivers the funds to entrepreneurs.

The *muḍāraba* contract has been chosen as the cornerstone for the operations of modern Islamic financial intermediaries because it is considered (a) to be the most convenient instrument which has its roots in the Islamic legal traditions, *ḥadīth,* and (b) to fulfil the Islamic concept of a 'just' economic transaction, as it includes the element of risk, for all parties.

The validity of *muḍāraba* as a basis for the operations of Islamic banking has been questioned by some Muslim scholars.[64] It has been argued that this contract was developed in the Middle Ages, related to a particular time and conditions. This contract lacks the legal basis to be valid in a complex industrial society for carrying out modern financial activities.[65] This argument is based on the assumption that contemporary Muslim jurisprudents do not have the right to reinterpret earlier legal principles.

The *muḍāraba* contract has also been rejected on politico-ideological grounds.[66] It is argued that Islamic banks, established by Muslim capita-

[63] See Udovitch (1970), pp. 170-248, and Saleh (1986), pp. 92-114.

[64] Haque (1985), pp. 190-214, and Muslihuddin (1976), p. 37.

[65] Haque (1985), p. 199f.

[66] Ibid., p. 213.

lists, will exploit small savers by using a medieval religious financial instrument as a legal device. The shareholders of Islamic banks would expose the funds of small depositors in order to make 'an exorbitant profit without risking their wealth'.[67] Finally, the introduction of *muḍāraba* as an alternative to interest has been criticised on the grounds that it will create or enlarge an informal financial market based on interest earnings.[68] Savers would prefer to lend their funds for a price or a hidden interest built into the repayment of the principal sum rather than deposit them in a risky *muḍāraba* bank.

Another important instrument applied by Islamic banking to providing finance is equity participation, *mushāraka,* whereby two or more partners contribute to the joint capital of an investment.[69] A financial intermediary may participate in a new project or in an already established company by buying equity shares. The financial results are also regulated, as in the case of *muḍāraba,* according to the profit and loss sharing principle (PLS). The profit is shared according to a predetermined proportion. Both parties bear the risk of financial losses. The bank is also entitled to be represented on the board of directors of the enterprise, and has voting rights.

In addition to financial techniques based on PLS, Islamic banking provides other financial instruments such as mark-up *(murābaḥa),* leasing *(ijāra),* and lease-purchase *(ijāra wa-iqtinā').* Contrary to the PLS contract, these instruments are based on a predetermined, fixed rate of return and are associated with collateral.[70]

The mark-up contract, *murābaḥa,* implies that a bank purchases a certain asset and sells it to the client on the basis of cost-plus profit contract.[71] The additional cost is negotiated and established in advance for both parties. The total cost is usually paid in instalments. The ownership of the asset is transferred to the clients in proportion to the paid instalments. Thus, the purchased product functions as collateral until the entire cost is paid. The bank may request a collateral from the client.

67 Ibid., pp. 214-6.

68 Abū Saud (1981), pp. 73-5.

69 HIB (1982). vol. 5, pp. 194ff.

70 Ibid., pp. 196- 200.

71 HIB, vol. 5, pp. 329-33.

The leasing contract, *ijāra,* is similar to any leasing activity provided in the traditional financial system. The bank leases a purchased asset to its clients for a fixed period, the rental amount being agreed in advance. The contract is termed lease-purchase contract, *ijāra wa-iqtina',* when a leasing contract is completed by the transfer of the ownership of the asset to the clients. Beside some minor variations in the legal technicalities, the mark-up and leasing contracts do not differ from those used by the traditional banking system other than in their terminologies. The rate of return is fixed and known in advance, and the purchased goods serve as collateral. The use of these instruments is considered to conform to Islamic financial principles, since the rate of return is tied to each transaction rather than to the time dimension. For two main reasons, these instruments receive weak support from some Muslim jurisprudents, who advocate a restrictive application thereof.[72] Firstly, they are associated with risk avoidance. The additional costs associated with transactions provided according to these instruments are fixed and determined by the bank in advance. For example, the bank adds a certain percentage to the purchased price as a profit margin. In addition, the purchased assets serve as a guarantee, and the bank may also require the client to offer a collateral. Thus, the predetermined fixed cost and the collateral offered in association with these instruments ensure that the risk taken by the bank is negligible. Such arrangements are considered to contradict the Islamic spirit of sharing the risk between the financier and the entrepreneurs.[73]

Secondly, according to the legal opinion, the additional costs may include only *recognised* expenses and *legitimate profit.* However, many scholars recognise that the bank may include a premium, based on previous experience, as compensation for the delayed payment, which strongly contradicts Islamic financial principles. Therefore, a number of scholars advocate that the use of these instruments should be restricted to 'unavoidable cases'. However, there is no explanation of what it is meant by unavoidable cases.[74]

72 Siddiqi (1983), p. 49f, and Khan S.R. (1987), p. 145-7.

73 Siddiqi (1983), p. 115.

74 Ibid., pp. 137-9.

Can an Islamic Financial Institution Maintain its Identity in the Long Run?

As has been recognised above, an Islamic financial institution must offer financial transactions subject to ideological restrictions. Firstly, all parties engaged in a transaction must be exposed to the element of risk, *mukhāṭara*. Secondly, an Islamic financial institution is obliged to fulfil socio-economic objectives. These restrictions may lead to a lower financial efficiency as the transaction costs will increase.

Providing capital on the *muḍāraba* basis is also linked with many inherent difficulties. This contract is associated with serious incentive problems, which will in turn lead to an inefficient financial market. Many Muslim savers, for example, will refuse to deposit their funds in a financial institution on the basis of risk sharing. In the long run, the lack of such devices as a savings instrument with a fixed rate of return will induce a lower rate of financial savings. Or an informal financial market may be developed in order to meet the preference of some savers. Many studies have shown that savings in Islamic banks decrease when the rates of return decline.[75]

Many entrepreneurs with a high risk project will request funds on the basis of the profit sharing principle so that they will not suffer from losses because there is no collateral requirement. Other entrepreneurs with an acceptable level of risk will prefer to pay a fixed cost and keep the profit. Many entrepreneurs do not allow the suppliers of funds to interfere with the management and monitoring of the investment. Finally, the determination of the rate of return as a variable ratio of profit will cause problems, particularly when the contract is undertaken for short-term finance for consumption. However, many Muslims argue that in an Islamic society the individual should not live beyond his means. Therefore, Islamic financial institutions should not grant loans for consumption.[76]

Furthermore, in a real economic situation, an Islamic financial institution is sometimes obliged to choose between maximising a profit and providing socio-economic benefits. Thus, there is a trade-off between pecuniary and ideological objectives. The religious restrictions will curtail the pecuniary profits.

[75] See, e.g., Kazarian (1993).

[76] Khan M.A. (1982), p. 241.

The inefficiency problems, mentioned above, are crucial in a competitive financial environment. There are unlimited opportunities for some institutions to violate the Islamic ideology in order to increase the profit. Therefore, some institutions and individuals will prefer to replace a *muḍāraba* contract wiith other financial instruments, where collateral may be required and a fixed rate of return can be charged such as *murābaḥa* and *ijāra*.

The main conclusion which may be drawn from many studies dealing with the experiences of Islamic banks located in Egypt, Iran, Pakistan, or the Sudan is the failure of these banks to adopt an Islamic financial-economic approach. The main activities of these banks were not founded on profit and loss sharing principles, but rather on traditional financial practices – financial instruments based on a fixed rate of return.[77]

Socio-religious preferences

According to Muslim scholars, the Islamic norms will induce a Muslim to act for the benefit of Islamic society, even at the expense of his own interest.

> A truly Muslim entrepreneur who can serve...society by offering better goods at cheaper rates will never manipulate prices to increase his own profit.[78]

In addition, the actions of a Muslim are considered to be determined by the Islamic altruistic incentive. One of the most fundamental Islamic economic injunctions, which is argued to function as a spiritual incentive, is to contribute to the social solidarity of religious brotherhood. Well-to-do Muslims are encouraged to contribute to the improvement of the economic conditions of the needy. Contrary to a capitalist society, this socio-economic objective is to be attained by individual actions rather than by pressures enforced by laws and rules. The economic actions of a Muslim are expected to be promoted and directed by the Islamic moral norms and codes, those of the *Homo Islamicus*. As Umer Chapra argues:

> These goals have been closely integrated into all Islamic teaching so that their realisation becomes a spirituel commitment of the Muslim society.[79]

[77] See Kazarian (1993), Chapter 10.

[78] Siddiqi (1972), p. 31.

[79] Chapra (1985), p. 36.

The behaviour of a Muslim economic agent is, of course, determined to some extent by the Islamic normative system. There is no doubt that the actions of an economic agent need not be guided only by rationality and determined solely by expected future rewards but can also be dictated by ideological norms. A Muslim may be willing to sacrifice a share of his wealth to benefit his "brothers in religion". He may be willing, for example, to deposit his fund in an Islamic bank and accept a rate of return lower than the market rate. This lower rate of return can be considered as a premium paid by a Muslim for satisfying his religious preferences.

The Islamic norms were created, and probably also effective, in a homogeneous society characterised by strong ties of kinship, as for example in the seventh century. At that time, the economic agents belonged practically to the same tribe, where each member could be identified by the others, and any deviation from the prevailing norms and customs was punished by sanctions, ranging from loss of esteem to exclusion from the community, and thereby to defenselessness and exposure to predatory tribes. The Islamic society has since expanded and become heterogeneous. Islam embraces societies with a wide variety of ethical, political, cultural and geographical characteristics. Norms are less effective as an incentive, and a restriction mechanism when the society expands and becomes heterogeneous. In a large society, where members cannot easily be identified, it is more difficult to induce the individual to make voluntary sacrifices for some segments. It is also difficult to impose sanctions when norms are violated. Consequently, homogeneously defined norms and values can not be accepted by all members. The violation of a specific norm by one group need not be considered illicit by another.

Secondly, the earlier Islamic norms were developed in a simple economic environment. At present, the mode of production in the Islamic societies is relatively advanced. This means that the Islamic norms will become more ambiguous when they are applied to a different, modern economic situation. There is plenty of evidence concerning controversial interpretation of laws and rules derived from the Qur'ān. The problem will of course become greater with regard to the application of Islamic norms of behaviour, particularly if these norms cannot be derived from and legitimised by the actions of the Prophet Muhammad and the four Caliphs.

The Establishment of a Religious Supervisory Authority

In order to ensure that the practices and activities of Islamic financial institutions are in accordance with *Sharīʿa,* a compulsory religious supervisory authority may be established. The task of this authority will be to provide detailed rules and recommendations which will guarantee that the activities of the financial institutions are sound from a religious point of view. The authority will also be obliged to monitor and control these institutions on a regular basis. In addition, financial mediations will be subject to financial regulations which are intended to create a sound and safe financial system. However, severe constraints – religious and regulations – may increase the transaction costs for the financial institutions and lead to an inefficient financial sector. Currently, there exists a Religious Supervisory Board (RSB) in the majority of Islamic banks. This board consists of Muslim jurisprudents, who act as advisers to the officials of the banks. The RSB is set up as a permanent institution located at, and financed by the bank. The opinion of the RSB is published in the bank's annual report.

Extension of the Definition of the Term Risk, Mukhāṭara

At present, Islamic financial intermediaries have extended the definition of the term risk, *mukhāṭara,* from two to three parties: the supplier of funds, the bank, and the user of the funds. In addition, a depositor in an Islamic bank does not take a risk in a specific project. His risk is related to all activities carried out by the bank. The bank has the right to aggregate the profits from different investments, and to share the net profit with the depositors according to a predetermined ratio.

Furthermore, a depositor may benefit from the profit of a project which took place before he opened an account. At present, an Islamic bank pools the returns from various projects which cover different periods. This implies that a depositor may benefit from the profit of a project and/or may bear the loss of a project which was completed before he opend an account. The return to the depositor is dependent upon the duration of his deposits.

In some countries, e.g. the Sudan, Pakistan and Iran, where Islamic financial institutions offer investment certificates for financing government activities, the risk is related to all the economic activities in the country. The rates of return on these certificates are also fixed in advance.

Nevertheless, it should be noted that there is no discussion among Muslim jurisprudents concerning the religious legitimacy of the bank's procedure for the distribution of the return on investment accounts. From a religious viewpoint, the fact that the returns to the depositors are not related to a specific project but rather are tied to a time dimension implies that this system is similar to that based on interest.

In summary, Islamic banks may in the long run maintain their religious identity in countries where sanction mechanisms are established, which will make deviation from what is religiously acceptable very costly. However, this may occur at the expense of an efficient financial system defined in strict pecuniary terms. Alternatively, what are considered Islamic requirements for the identity of an Islamic bank may be modified in a sense that incentives for various legal devices may be encouraged.

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