BANKING WITHOUT INTEREST
AN ALTERNATIVE TO MODERN BANKING SYSTEM

BY

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DEDICATION

This project is dedicated to my parent :-

Alhaji Isma'il Sa'eed Yakasai [late]

Hajiya A'ishatu Isma'il Yakasai

DECLARATION

This project is a record of my own personal effort and work; and its original has not been submitted in any for elsewhere.

CERTIFICATION

Banking without interest: AN ALTERNATIVE TO MODERN BANKING SYSTEM, is a project prepared and submitted by Abdullahi Ismaila Yakasai in partial fulfilment of the requirements for the award of master of business administration (MBA). It has been produced under my supervision and fully satisfied for meeting the requirement of the business administration department for the award of an MBA degree of Ahmadu Bello University Zaria. Nevertheless it is approved for its contribution to knowledge and literacy presentation.

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CHAPTER ONE

INTRODUCTION

The money and Banking sector in any economic system does not operate in an ideological vacuum. It has it's own philosophical background and objectives. It's institutions evolve gradually to perform the functions necessary for enabling the system to realize it's basic goals and to perpetuate itself by surviving the recurring shocks of history.

The capitalist money and Banking system is also essentially an integral part of it's parent ideology. It serves the objectives of capitalism. And the capitalist economic system is contrary to the dictates of Islamic injunctions. However, there is nothing inherently wrong in borrowing institutions from other cultures provided that they are modified appropriately to serve the goals of the guest culture. The important thing to ask here; is whether the capitalist money and Banking system which is gradually adopted by Muslim countries for the past centuries can be made to serve the goals of Islam instead of those of capitalism without any fundamental reform? In this respect the answer could be positive only if it is assumed that the goals of capitalism and Islam are the same or the financial institutions in

capitalism are ideologically neutral and do not help the system per-se to realize its inherent objectives.

The Banking system, as it exist today has evolved (over centuries) Riba/usury/ or interest in its undiluted form. And Riba Al-Nasia is the foundation upon which the conventional Banking system is established. However, in Islam Riba is strictly prohibited while trade has been allowed (II:275) as an economic alternative. A pre-determined and Risk-Free return on capital (i.e. interest/Riba) plays a private role in regulating the supply of money, control of credit, movement of opportunity capital, fixation of exchange rates, evaluation of projects and in determining the investment climate. Its unfortunate that Riba/ or interest is now so deeply rooted that even some muslims had started accepting it as an inescapable evil, like an old sore which has lost its severity and from which there is no escape.

In retrospect, the word "BANK" is said to be derived from the Italian word BANCO, a bench. The early bankers were the Jews in Lombardy, who transacted their business on benches in the market place.

Maclead, in his book "Elements of Banking" says: "At that period the Germans were Masters of a Great part of Italy; and the German word BANCK came to be used as its Italian

equivalent MONTE, and was Italized into BANCO or MONTE". In addition, it should be noted that Chinese are said to have been the Inventors of Bank notes about the year 119 B.C.[1] Nevertheless, the origin of modern Banking was said to have started with the Gold Smiths who in their routine operations collected their customers gold either for melting to make ornaments, or just for safe-keeping. From their experience on the average duration of customers gold deposits placed with them, they realized that they could use part of the deposit for business and also for onlending a proportion of it to willing borrowers. They however, discovered that by keeping for example 50% of the total deposits, they could lend to others (the other 50%) or engage in business themselves without risking their ability to pay on demand, whatever gold deposits the customer wished to withdraw.

It is of paramount importance to note that, the capitalist banking system is the Jewish perfection of the perversion of the teachings of the only true religion of God which Prophet Musa (A.S.) taught the Israelites that:

> "If you lend money to one of my people among you who is needy, do not be like a money lender, charge him no interest".[2]

> "Prophet Musa (A.S.) also taught as follows:

> Do not oppress an alien, you yourselves know how it feels to be aliens; because you were aliens in Egypt".[3]

Later the Jews started to desert the teaching of Prophet Musa (A.S.). This perversion is contained in DEUTERONOMY VERSE 19, where it is stated:

> "You shall not lend upon interest to your brother, interest on money, interest on victuals, interest on anything, that is lend for interest. To a foreigner you may lend upon interest, that the lord, your God may bless you in all that you undertake in the land which you are Entering to take possession of".[4]

There are the perverted teachings of racial superiority and domination on which the capitalist banking system is based. And this proves Allah's (S.A.W.) saying:

> But those of them who did wrong charged the word which had been told to them for another saying, and we sent down upon them Wrath for their wrong doing". (7:162)

1-1 BACKGROUND

1-1-1 THE GREEK THEORIES OF INTEREST

A highly civilized nation such as the ancient Greeks, lending money at interest was forbidden. Aristotle whose powerful indictment greatly influence the later generation condemned the taking of interest in very strong words In his analysis, Aristotle compared money to a Barren Hen which laid no eggs. According to him, the sole object of the use of money was to facilitate exchange, and the fuller satisfaction of human wants. To him this was the most natural purpose of money. He remarked that: money could not be used s the source of accumulation (i.e. to increase at interest/Riba). So, accumulating money at interest was the most unnatural of all the ways of making money. The doctrine of Aristotle was that:

"A piece of money can not beget another piece".[5]

Plato in his book "LAWS" has condemned interest.[6] Nevertheless, it could be seen apparently that interest was considered detrimental and unjust even during the ancient Greek era.

1-1-2 THE ROMAN THEORIES OF INTEREST

The Roman Empire prohibited the charging o any interest at the initial stage.

But gradually with the extension of the empire and the rise of the trading classes, interest emerged, but severe restrictions were imposed on the rates of interest to be charged. Lawis Haney in his book "History of Economic Thought" mentioned that Romans were the first nation to enact laws for the protection of debtors.

1-1-3 INTEREST IN THE MIDDLE AGES

Interest payment on money loans was named Usury in the middle Ages, and the charging of Usury was strictly prohibited by the common laws. During this period, it has become a common place to 'Dub' these prohibitions as mere religious Dogmas. At this juncture, professor Tawney (a profound writer) remarked that:

"The whole scheme of medieval though attempted to treat economic affairs as a part of hierarchy values embracing all interest and activities of which the apex was religion"[7]

It is pertinent to ask here whether medieval thinkers had out better sense of the nature of things than what their later successors possessed.

In this connection, the following remarks of Lord Keynes are worth-noting. Keynes believes that there was also an economic motive behind the medieval prohibition of usury. He observes;

> " I was brought up to believe that the attitude of the medieval church to the rate of interest was inherently absurd and that the subtle discussions aimed at distinguishing the return of money-loans from the return of active investment were mere jesuitical attempts to find a practical escape from a foolish theory. But now I read the discussion as an honest intellectual attempt to keep separate what the classical theory has inextricably confused together namely the rate of interest and the marginal efficiency of capital".[8]

However, up to 13th century, the Church rule was supreme and the charging of interest was strictly forbidden. It is significant to note that, the payment of rent for the services of land or durable goods was not condemned by the Church or the canon law.

1-1.4 THE DECLINE OF THE INFLUENCE OF THE CHURCH

Towards the end of the 13th century several factors appeared which considerably undermined the influence of the orthodox church. Luther and Zwingle the leaders of the reformist group agreed to the charging of interest/Riba on the plea of human weakness. And with the gradual decline in the power of the Church and the rise of the secular power, the lending out on interest/Riba began to be tolerated.

Bacon (a renowned scholar) remarked:

> "Since of necessity, men must give and take money on loan and since they are so hard of heart that they will not lend it, otherwise there is nothing for it, but that interest should be permitted".[9]

Consequently, the forces of Greed and Avarice were let loose and consequences emerged. Gradually, prohibition against usury began to be renewed in Europe. In England, the Ban was renewed in 1545, during the reign of Henry viii. It was at this period that, the word usury began to be progressively replaced by the word interest.

1-1.5 THE INTEREST THEORIES IN THE MERCANTILISTIC ERA (1500-1700)

Man's brutal and selfish tendencies were kept under restraint by the forces of religion, for many decades. But with gradual decline in the power of the Church and release of selfish forces from the strong Anchors of Religion, people began to move with the selfish forces of the times. Once the rule regarding the charging of interest was relaxed, it no longer remained possible to control the rate of interest. It was at this period that money began to be used on a large scale for commercial transactions and exchange began to replace Barter.

The early mercantilists advocated low rate of interest to encourage trade. In effect, they strongly advocated for the statutory fixation of low rates of interest.[10] In the year 1985, there arose a controversy over usury/Riba. In conflict with Mun's view, Sir Thomas Culpeper had written two tracts in favour of establishing lower interest rates and his son published a Discourse attacking usury.[11]

But perhaps the must eminent sponsor of this notion was Sir Josiah Child. He maintained that a law interest rate was the natural mother of frugality and industry, and that it would attract trades by making capital cheap and compel frugality by

making smaller "profit" necessary. While the high rate of interest made money scarce because every man as soon as he had saved a little, sent it to the Goldsmith. According to Thomas Manley "it is the scarcity of money (& money borrowers) that make the high rate of interest ...so plenty of money and few borrowers will make the rate low". Nevertheless. inspite of their efforts, the merchantilistic failed to control the rate of interest. Hence the rate of interest was left to itself to be determined by the forces of supply and demand, as obtainable in a free market economy.

1-2 STATEMENT OF THE PROBLEM

The present day world is experiencing a number of economic ills including poverty of a large proportion, social and economic injustices, Gross inequalities of income and wealth, High rate of unemployment, economic instability inflation and erosion of the real value of monetary assets.

All these maladies; inspite of being in conflict with the value system of Islam, are as prevalent in the Muslim World as elsewhere. No doubt they have a number of root causes. However, the failure to provide a stable and just money and Banking framework has been one of the major contributory factors for the said calamities, in particular. And the lack of an ideal political system that recognises the supremacy of

the Lord as the sovereign and divine law-maker, in general. Islamic banking is an intergral part of a functioning Islamic economic system, but the Islamic economic system is only a part of an Islamic social system that possesses well-identified characteristics based on islamic law. The criterion by which an economic system claiming to be Islamic can be measured, is the extend to which Islamic law has been implemented and embraced by the society.

1-3 OBJECTIVE OF THE STUDY

The main objective of this study is to awaken the Muslims (who are highly involved in Usury/Riba transactions, in particular and the entire world at large) that, they should not sell their Hereafter in exchange for the (little) earthly comfort. Involving, in usurious transaction amounts to a war with God (S.W.A.) and His Messenger (S.A.W).

> "If you do not,take notice of War from God and His Apostle..." (11:279).

The worst aspect of it is the constant attempts being made by some Phedo Islamic scholars to Justify the whole issue as "LARURAH"; instead of discouraging the patronage of usurious transactions through enlightening the Muslims about the disastrous implications contain therein, as well as

propagating an Islamic alternative as a substitute and solution to the present conventional banking system. Unfortunately, this abominable act have swallow the faith of a good number of believing Muslims globally.

The proponents of interest based banking system seek to justify it on the grounds of declining value of money over time (i.e Inflation) are in fact missing the point. Interest is the rate of return on financial capital, it is not the return or reward for waiting before consumption. All production elements viz; labour, physical capital, land and enterpreneul skills combined to produce a given product. Each factor of production should be paid the equivalent value of its contribution in the production. In the capitalist system financial, capital which translates into physical capital is paid a disproportionate share of the total output. It is a measure of the rate of exploitation by the owners of capital against the owners of other factors of production such as labour.

However, others argued that, interest paid or construction loans is the one that is forbidden while interest on investment and trade is permissible. In fact their thinking Horizon is highly limited. A salary earner may borrow money from an interest-based bank for family Needs and pays back at the end of the month with an additional interest charged.

Likewise the same person could also borrow for the payment of his children's school fees. Family feeding is a consumption activity no doubt about it but school fees payments are regarded as investment in the development of human resources. The question to ask here is,can there be any justification for charging interest on one and not also on the other?

Another area of concern is the existence of Riba at international level where one country borrows from another. For instance, Nigeria borrowed from abroad in order to import both direct consumption goods and capital goods (ie. machines and equipments) for industrial and agricultural production. The question here is, can one purpose be differentiated from another? Virtually, not possible. Hence, the attempt to justify interest/Riba on the ground of declining value of money (ie. inflation) over-time, is not tenable. It should be noted that, Muslims are not left in Darkness, every matter involves a religious injunction. A sound warning and a reminder is given here:

"O you who believe! observe your duty to Allah, and give of what remains from Usury if you are (in truth) believers" (II:278). And

"If you do not, then be warned of WAR (against you) from Allah and His Messenger ....." (II:279).

To set a War against the Al-Mighty is the worst of all evils and the negative repercussions needs no further explanation.

Syed Qutb, In his famous book "FIY ZILALEEL QUR'AN", while commenting on the verse (II:279) stated categorically that, the WAR is only limited to four persons, if the Usury affairs involved only two persons. But in a situation where the Usury transactions involved more than two persons ___ e.g. a group of individuals; the whole nation should take notice of setting a WAR from Allah and His Apostle. Because of it's extreme Negative position in the sight of the Al-Mighty, there is no HADDI (a prescribed punishment) for the consuming Riba. Unlike other offences like Adultery, alcohol drinking, stealing etc. But in the case of Riba Hell-fire is the place of abode for the offenders that died without repenting.

> ....."but those who repent (the offence) are companions of Fire; they will Abide therein (forever)". (II:275).

However, I hope these verses will be fully comprehended and will serve as a deterrent to the entire Muslims currently involved as well as those aspiring to join the conventional banking system. Moreover, it is of paramount importance to note that Allah (S.W.A.) have categorically stated that:

"Those who conceal the clear (signs) we have sent down, and the guidance, after we have made it clear for the people in the book, on them shall be God's curse, and the curse of those entitle to curse". "Except those who repent and make amends and openly declare (the truth). To them I turn; for I am oft-returning, most merciful" (II:159 & 160). And

"Those who reject faith, and die rejecting on them is God's curse and the curse of Angles and of all mankind". "They will abide therein! their penalty will not be lightened not will respite be their (lot). And your God is one God; there is no God but He Most Gracious, Most Merciful". (II:161 & 162).

"The Truth is from your Lord so be not at all Doubt". (II:147).

1-4 SIGNIFICANCE OF THE STUDY

A group of people exists in Islamic countries which, under the, belief that Islam is a rational religion, tries to reconcile Islamic theories with modern practices. For instance, with the onslaught of capitalistic economy, it becomes fashionable to believe that modern society could not exist without interest; and Islam too did not prohibit

interest; it only prohibit usury. It is suicidal spiritually for a good muslim to compromise with these unauthorized liberal interpretations. Personally, I believe that such persons, in view of the emphatic injunction of Quran against interest have done a great disservice to the cause of Islam by arguing that Islam has not prohibited interest, and that it has only prohibited usury. It should be noted that, interest and usury are mere words which easily shade into one another, but what is considered a reasonable rate of interest today may be regarded as a usurious rate tomorrow.

My belief is that if Quranic theories came into conflict with the modern scientific theories I find no reason to trouble my conscience. I firmly believe that the science of today may be the mythology of tomorrow and that what Quran has said we may not understand today, but it is likely to become quite clear to us tomorrow.

> "The theory of interest has for a long time been weak spot in the science of economics, and the explanations and the determination of the interest rate still gives rise to more disagreement amongst economists than any other branch of general economic theory".[12]

Nevertheless the importance of this study is to provide an alternative to the present predicaments caused by the

conventional banking system. In this thesis, the Nature, mechanism and operations of Islamic banking system will be thoroughly examined.

In effect the Islamic banking systems of Islamic Republic of Iran and Pakistan have been brought into light as a case study. It should be noted that, Islam outlaws the institutions of interest. And by so doing it implicitly rejects the interest productive capacity of the money capital of which interest is considered to be the reward in a capitalist economy. It should be of great significance to notice the frontal clash that exist between the Islamic teachings and the conventional (banking system).

The Qur'an enjoins that Allah (S.W.A.) permits BAI (ie. Sale/or trading) and forbids Riba/interest. Banks and other financial institutions in a truly Islamic economy can not operate on the basis of interest, their functioning needs to be restructured on the basis which carry the approbative seal of Islamic shariah.

While Allah (S.W.A.) permits trade and forbids interest the conventional banking system reacts contrary. Hence, this bring to fore, and irreconcilable legal position of the most fundamental nature which demands a solution of this frontal clash between the Man-made laws and the principles of shariah

on the basis of a highest priority.

1-5 RESEARCH METHODOLOGY

The design employed in this thesis portrays the parameters of Islamic dictates. So the data for analysis should virtually be in conformity with Islamic injunctions. Primary and secondary sources of shariah are employed as a tool to justify the content. The primary sources of shariah are the Holy Quran and the prophetic traditions; while the secondary sources of shariah contained in this Dissertation are the Ijtima-ul-uluma and Qiyas. Indeed, it is not fitting for believer to have an option beside that of Allah (S.W.A.) and His Messenger (S.W..A.) It should be noted that, the basic sources of laws of shariah are the Holy Quran and the Sunnah of the Holy Prophet (S.W.A.)

However, exegetic interpretations given by Islamic jurists and scholars have been aimed at devising practical rules for their application. Different interpretations in the same matter have been put forward by contemporary Islamic exegetists who lived on similar socio-economic conditions. Differences of opinions occurred inspite of intellectual honest and depth of understanding even between teachers and their students, who were well-known jurists in their own right. I am saying this only to emphasize the point that, the

exegetive interpretation of Islamic jurists must not be treated at par with the laws of the Holy Quran and the Sunnah but only to assist us for enhancing our understanding so as to enable us to device a set of practical rules for achieving the substance and objectives of shariah according to the variations in the socio-economic conditions (ie. IJTIHAD).

1-6 SCOPE AND LIMITATION OF THE STUDY

The thesis have traced the history of Al-Riba right from the Prophet Musa (A.S.) in respect of the attitudes of the Jews by then. The genesis of interest from the greek era to Roman as well as the Medieval era were fully discussed. Information in respect of the origin of the words "Bank" ,"banking system" "Usury/interest" and "Bank Note" have also been supplied.

Areas covered includes operating of a bank under the; paradigm of Islam. The Islamic Republic of Iran and Pakistan were taken as a case study. Comparison between the conventional and the Islamic banking system is also contain therein.

Areas of particular importance and needing further research included the following:

1. How the Islamic banking system affect the depth of the financial market and what are its supervisory

and regulatory pre-requisites?

2. How the operation of Islamic banking affect fiscal policy and what role does fiscal policy play under an Islamic system.
3. How are international capital flows determined between interest-based system and countries applied the Islamic system including the impact of the latter on external debt?

4. How do the two systems (ie. the conventional and the Islamic banking systems) interface and what role does exchange rate policy play in this context?

DEFINITION OF TERMS AND ABBREVIATION

BAI - Sale/trading

HADDI- A prescribed punishment stated in islam

MODARABAH - Is a business which a person participate with his money and another with his effort or skills or both his effort and skills and shall include UNIT TRUST and fund by what ever name called.

MUSHARIKA - No any legal definition is given: but as a mode of bank financing may be defined as an arrangement based on the principle of profit and loss sharing in which parties to the contract participate with money, effort or skill or a combination of them as may be provided in musharika investment agreement

QARD AL HASSANA - Interest free loan on passionate grounds.

RIBA/FIY MU'AMALAT AL-MUNUK - Is the fixed return for the use of money.

V Is representing the word Modarabah

S. W. A. - Subhanahu Wa Ta'ala

S. A. W. - Sallallahu Alaihim wa sallam

PLS - Profit and loss sharing

PTC - Participation term certificate

AS - Alayhis Salam

END NOTES

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CHAPTER TWO

LITERATURE REVIEW

2-1 THE ECONOMIST CONCEPTION OVER INTEREST

The most prominent school of economists who have moulded the destiny of economic science are the classical economists. And they are considered as the pioneers of the classical theory of interest, and their teachings occupy a very prominent place in almost all the Universities of the British Empire. Adam Smith, Robert Thomas Malthus and David Ricardo are usually considered the founders of this school. While Stuart Mill, Edgeworth, Marshall and Pigou are considered by many authorities today as the New Classical School.

According to Adam Smith and Ricardo (1947), interest was the compensation which the borrower paid to the lender for the profit he would make by the use of his money. Smith and Ricardo donot separate apparently interest from gross profit on capital. Let us see what they mean by capital. Adam Smith used the "stock capital" to mean that part of the wealth of an individual which was used not for his consumption but which was used for further production to bring him money, reward or profit. And which included machinery, raw materials, buildings, food and clothing. Food and clothing from the

community's point of view are not capital but, yet they are capital from the individual, since he can advance them to labourers in production and make a profit. However, David Ricardo's views are also practically the same. Accumulation of stock or capital was the result of parsimony and parsimony would not be practiced unless a reward was expected for the sacrifice.

Smith and Ricardo viewed interest as the reward or the inducement paid for savings. Smith went on to say, the origin of profits is to be found in the fact that, the employment of capital in production results in an increased value of the product over the labour value. Ricardo styled all capital as stored up labours and attributed all value to labour. Moreover, the rate of interest in their observation (i.e. the two writers) is "whenever a great deal can be made by the use of money, a great deal can be given for the use of it." '

According to, Daniel Hoare (1641) the rate of interest had nothing to do with the quantity of money. The impact of increase in the quantity of money was to increase prices. Ricardo shares this view and expounded his famous Quantity Theory of Money. Mars hall's contribution to the theory of interest lies in emphasizing both the demand and supply in determining the rate of interest.

Another able English Economist, Nassu Senior had used the word abstinence as the cause of interest, though,there were a number of objections against his concept. Marshall substituted the word waiting for abstinence. According to him interest on the supply side is the reward for the sacrifice of saving or waiting. The demand for capital depends upon its marginal productivity.

According to Samuelson (1980) "interest is the price or rental of the use of money."[2] Thus, he equates the price with the rental use of money considering, its service exactly as the services of a medical doctor or of a tractor. When money is sold, one should pay a "price" according to Samuelson, if borrowed, one should pay a rent. To sell money, there must always be some exchange of one good against another good - according to Samuelson.

Don Patinkin (1978) considers interest as a part of the functional share earned by capital goods as well as money-capital. It is strange that Patinkin does not give labour any share of the resulting income, while he allotted interest a share of the yield. It is clear that, this is not true because income is paid to the lender irrespective of the yield and perhaps even before the income is realized. At this juncture Patinkin treats capital goods as synonymous to money-capital.

Y.S. Bain (1980) stated that "interest paid for invested money is thus third distributive share in addition to wages and rents. It is paid for the services of invested money and it is earned by capital goods in which the funds are invested".[1] Professor Bain does not mention "profit" here and equate "the loanable funds" with capital goods. If interest was a functional share of the investment as he alleges, it would be negative if the process yields a loss - which is not the case. Besides, as long as the lender is not the investor, we cannot by any means tie up interest with the investment process.

J.M. Keynes (1978) did not define interest, but mentioned the rate of interest as "money rate of interest is the percentage of excess of a sum of units of money contracted for forward units of time over spot or cash price of the sum thus contracted for forward delivery".[4] In the course of analysing the reasons that make money rates of interest more acceptable than commodity rates, Keynes mentioned that;

"....the power of disposal over an asset over a period may offer a potentional convenience or security which is not equal for assets of different kinds, though the assets themselves are of equal value. There is, so to speak nothing to show for this at the end of the period in the shape of output, yet it is something for which people are ready to pay something".[5]

2.1-1 CRITICISM OF THE CLASSICAL THEORY

According to the classical economists it is the rate of interest which brings about the equality between savings and investment. If savings is in excess of investment, the rate of interest falls, and investment is stimulated so that equality between the two is restored. Lord Keynes rightly objects to this. His view is that, it is the level of the income rather than the rate of interest that ensures this equality. Savings depends upon the level of employment and incomes. Lord Keynes has reached the foregoing conclusion in his assertion that the supply schedule of savings is not an independent one but it is entirely dependent upon the schedule of investment. He concludes;

> "The initiative lies with the entrepreneurs and not with the savers. The savers, as a group, are helpless in the hands of the entrepreneurs though any one individually is free to save as much as he like".[6]

The defects in the classical theory is that it is based on the assumption of a constant level of income for the community which is unreal. Again savings are not determined by the rate of interest alone. In this connection we have the weighty authority of Professor Gustav Cassel who observes;

> "Amount saved by individuals out of a given income is largely insensitive to changes in the rate of interest. With a rise in the rate of interest some may save more, or some less than they did before. The motives behind an act of savings are complex. The proportion of its income which a community saves, depends upon the size of it's income, desire for security and power and psychological states of preference as between the present and the future. Hence, net savings is likely to be affected very little by changes in rates of interest".[7]

Taking a mechanistic view of society by the classical theory of interest is a fundamental defect per-se. Because, it is not necessary that an increase in the savings by itself will lead to a corresponding increase in investment or investments are likely to be encouraged or discouraged by the low and high rates of interest. The truth of these objections is very well demonstrated during the periods of booms and depressions when in the latter case inspite of an increase in the rate of interest, there is no corresponding stimulus to investment.

Another significant defect in the classical theory is that, it failed to realise the fact that savings may not be invested, but may either be loaded or left in the form of idle cash.

2.1-2 THE ABSTINENCE THEORY OF INTEREST

According to **Nassu William Senior** (1500), interest was the price paid for abstinence. And by abstinence he meant the conduct of a person who either abstained from the unproductive use of what he could command or designedly preferred the production of the remote to that of immediate results. His observation was that;

> "To abstain from enjoyment which is in our power to seek distant rather than immediate results are amongst the most painful exertions of the human will - of all the means by which man can be raised in the scale of being, abstinence, as it is perhaps the most effective, is the slowest in it's increase and the least generally diffused".[8]

The defect of the above assertion is that N. Williams Senior fails to mention the sacrifice incurred by abstinence by different groups of people of varying incomes. So he was attacked by Lasalle, (a socialist writer) who remarks that;

> "the profit of capital is the wage of abstinence, Happy , even priceless expression. The ascetic Millionaires of Europe like Indian penitents or Pillar Saints, they stand

> on one leg each on his column, with straining arm and pendulous body and pallid looks, holding a plate towards the people to collect the wages of their abstinence. In their midst, towering up above all his fellows, as a head penitent and ascetic, the Baron ".[9]

Professor Cassel and Mr. Henderson (1621) criticised the theory of abstinence on the ground that one cannot find any satisfactory cause of interest in this theory. According to them the rate of interest does the function of directing investments only to those channels of which are most fruitful. In Henderson's view, it (ie. the rate of interest) separates the sheep from the goat. According to him, it serves as a screen by means of which capital projects are sifted, and through which only those are allowed to pass which will benefit the future in a high decree.

N. Williams Senior's theory is rather defective and fails to impress us, but his contribution in one respect is important, *for he was the first economist to bring to prominence the importance of the time element in the employment of capital.*

2.1-3 THE PRODUCTIVITY THEORY OF INTEREST

The proponents of the above theory consider productivity as a **property inherent in capital** and buttress that, this

productivity of capital is the cause of interest.

According to Bohm Bawerk (1640), productivity of capital could be interpreted into four (4) ways:

1. Capital has the capacity of serving, towards the production of goods.
2. Capital has the power of serving, towards the production of more goods than could be produced without it.
3. Capital has the power of producing more value than could be produced without it.
4. Capital has the power of producing, more value than it has itself.

In essence, there is circulation of value over and above the value of capital consumed in production.

The defect of the productivity theory of interest is that, it gives an only subordinate rate of money and expectations. While from experience, an increased productivity of goods results in a fall of the price of those goods. And sometimes a fall in prices may be so great as to make the actual rate of interest earned to be negative. Moreover, the theory also fails to explain why interest is charged from consumption goods.

The productivity theory, which is essentially a static theory, safely neglects the importance of money and credit. The theory although it explains to some extent as to why interest is paid especially in the case of productive loans, fails to give any adequate explanation as to how the rate of interest is determined and also gives no explanation as to why interest is paid or demanded when the borrower suffers losses by the employment of borrowed capital.

2.1-4 THE AUSTRIAN THEORY OF INTEREST

The aforementioned theory, otherwise known as the Agio theory of interest is mainly the work of Bohm Bawrek. His great contribution to the theory of interest and capital is his concneption of the capitalistic method of production as a time-consuming process, and his view of capital as nothing, but intermediate goods. Bohn Bawerk proceed to analyse the cause for the existence of interest to us. His theory of interest (also called Time Preference Theory) can be conveniently divided into two parts.

PART A: Interest As An Exchange Phenomena

He finds the cause of interest in the fact that human beings prefer goods to future goods of like kinds and number. His remarks was that;

> "Present goods are as a rule, worth more than future goods of like kind and number. This proposition is the Kernel and the centre of the interest theory which I am going to present".[10]

The premium which we are prepared to for the present goods as compared to the same goods in future is termed by him as **AGIO**. This could be illustrated as follows; suppose, a person borrows =N=100 at present and promises to return back =N=103 a year hence. Here there is an exchange of present money for future money. According to him the =N=103 returned a year hence, is the equivalent in value to the =N=100 lent at present. In other words, the surplus value of =N=3 of the sum returned over the sum borrowed is only apparent. This premium or Agio of =N=3 on present money is interest. In other words, interest is the complementary part of the principal lent. According to Bohm, a loan without interest is equivalent to a sale below market price. At this juncture, one will be pertinent to ask as to why people prefer present goods to future goods. Bohm Bawerk, gives three (3) reasons for this;

1. Under-estimate of the future, which could be due to the following:
   a. want of imagination
   b. defect of will and
   c. uncertainty of life, etc.

2. Differences in want and provision for want. People who are in need at present prefer present wealth to future wealth.

3. Technical superiority of the present goods.

PART: B **Interest as an Economic Necessity**

At this juncture, the very psychological subjective foundations on which the theory is built are wrong. For the simple fact that, a very large majority of people save for the future, because they consider that their future needs will be greater relative to the present needs; such as savings for education and marriages of children, provision for old age, etc.

Berrand Russel attack the above theory by pointing out the following observation:

> "Most of our activities in the acquisition of wealth may ultimately be traced to our desire for personal prestige and social power".[11]

According to him, the Agio theory, if examined critically, there will hardly be any substantial difference between this

theory and the Abstinence theory.

However, the theory propounded by Bohm Bawerk has been completed by a prominent Swidish Economist called Kunt Wiucsel. Wicksel asserts that, interest is the difference between the marginal productivity of the direct and indirect uses of the factors of production and that when there is an increase in capital, different existing capital investments are not increased proportionately, but that relatively longer investments predominate and that through this an increase in wages and the prices of the original services due to that increase of capital is counteracted. Wicksell's most contribution to the theory of interest and capital is that, he tries to establish a relationship between the rate of interest and the price level. He was one of the first to recognize the monetary character of the rate of interest.

All the aforementioned theories of interest could be conveniently be labelled under a general heading of Pure theories of interest or otherwise, the Non-monetary theories of interest.

2.1-5 THE MONETARY THEORY OF INTEREST

The above theory considers interest as essentially a monetary problem. The proponents of these theories are less

concerned with the cause of the existence of interest and more with the determination of the rate of interest. A pertinent observation could be made here, (the implication of which we shall scrutinize later on when discussing, Islamic contribution to the theories of interest) - that if one is not clear about the causes of existing of interest, how one can jump to explain the rate of interest.

According to the monetary theories, the rate of interest is essentially a money rate and hence it's determination is purely a monetary phenomenon. Hence, the theories of interest conceived by the monetary approach yield two rival theories. The "loanable fund" theory and the "cash balance" (or otherwise known as the liquidity preference theory). The differences between the two rival theories rest on this: "is the rate of interest determined by the supply of and demand for loanable funds (or credit or claims), or is it determined by the supply and demand for money itself".[12]

Professor Bertil Ohiln Robertson, Hick (1937) and other reknown economists are among those who held the view of loanable fund theory of interest. While Lord Keynes and his followers held the view of cash balance / or liquidity preference theory. It should be noted that, the loanable fund theory of interest is the first step in the transition from the classical to the modern theory. This theory (loanable

fund theory) of interest is based on a thorough analysis of the concept of savings and investment.

The main difference between this school and the Keyness school (ie. the cash balance theory of interest) is that, Lord Keyness believes that savings and investment are always equal. But this school disagree with that view.

According to Mr. Lerner (1938), the loanable fund theory could be precisely stated as follows;

> "The rate of interest is the price that equals the supply of credit or savings plus net increases in the amount of money in a period to the demand of credit or investment plus the net hoarding, in the period".[1]

This school believes that normally the amount saved from the current income is largely insensitive to the changes in the rate of interest, at least in the short period.

Another fundamental difference between the loanable fund theory and the theory expounded by Lord Keynes (i.e. the cash balance theory of interest) is that, the latter believes that irrespective of any rate of interest savings or investment are always equal. Keynes observation was that, it is not the rate of interest that ensures the equality between savings and

investment but the level of income. His remarks is that, interest is simply the premium obtainable on current cash over deferred cash. It is not the price or reward for saving or not spending, but it is the payment for lending money. It is the reward for not hoarding or the reward for parting with liquidity for a specified period. It is a measure of the unwillingness of those who possess money, to part with their liquid control over it. It is a price which equilibrates the desire to hoard wealth in the form of cash with available quantity of cash. In otherwords, it is a reward both for not spending and not for hoarding.

But, as already pointed out there can hardly be any justification for the payment of interest when we realize that a very large part of saving in every civilized country is not the result of individual saving, but savings are created by banks and other such financial institutions. The only reason for the payment of interest, which one finds from these monetary theories of interest seems to be that the cause for the payment of the interest is the opportunity for making a gain, with the use of money borrowed. It seems to us, that Keynes being the victim of his environment does not take enough courage in his hands to condemn the charging of interest out-rightly.

Hence, his theory in conclusion, naturally leads him. And

there is no escape from the conclusion that fixed rates of interest are highly detrimental to the word progress. In essence, all the theories of interest of the leading Western economists have relinquishly depicted their loopholes and defects. So, we shall now consider the Islamic theory of interest and show it's superiority over the preceding theories.

2.2 THE ISLAMIC JURISPRUDENCE VIEWS OVER INTEREST

The Holy Qur'an and the Sunnah - the two fundamental sources of Islamic law have strictly forbid interest for it's tyranny. The Holy Quran has laid down rather strict injunctions with regards to interest on money. These injunctions are repeated over and over with the same force and emphasis. See the following Surahs. Suratu Rum XXX:39, Nisa'i IV: 160-61, Al-lmran III: 130 and Baqarah II: 275 - 79.

Despite the above verses, it's unfortunate that some learned Muslims, blinded by the superficial charm of the European civilization are of the opinion that, what Islam prohibits is usury and not interest. They opine that interest paid on loans for investment in productive activities would not contravene the law of the Holy Qur'an for it refers only to usury on non-productive loans which prevailed in pre-islamic period. The time when people were not familiar with

productive loans and their influence on economic development.

In this, the propounders of the theory would appear to have overlooked that the Holy Qur'an, the Ultimate of the Divine message to human guidance, legislates for all ages and that God's knowledge as embodied in it couldnt be substituted by economic practice of interest on productive loans known to this or any other age. In fact, the difference between productive and the so called unproductive loans is a difference of degree, not kind. However, calling usury or riba by the name interest will not change it's character since interest is nothing but an addition to the borrowed capital, which is usury in both spirit and islamic code of law.

All the Jurists and most of the expounders of Qur'anic exegesis, like Imam Tabari, Imam Zamakhshari, Imam Al-Suyudi, Imam Al-Baidawi and Imam Ibunl-Arabi, have discussed the problem of interest within the legal parameters of the Riba per-se. Imam Razi is the first person who has shed light on this problem from the economic context.

According to Imam Razi, the word Riba means and indicate "increase or addition. But it does not mean that every kind of increase is unlawful. What is, however, illegalized is that particular contract which the Arabs called 'Riba'. This is exactly what they named Riba Nasi'a. What, therefore, has

been declared illegal or unlawful in the Holy Qur'an is the same Riba Nasi'a. The people of the Jahiliyyah according to Imam Razi, used to advance their money and recover Riba monthly without affecting the sum advanced. When the time for settlement came, the principal amount lent was demanded and if the debtor was unable to pay, the lender increased the amount in his own favour and granted extension of time".[14] This was how the Arabs of the Jahiliyyah used to transact their lending operations.

Imam Razi also remarks in connection with chapter III: 130 ('O you who believe! Devour not usury, Doubled and multiplied; But fear God; that you may (really) prosper) that, "in pagan days when a sum of one hundred Dirhams were due to a person from another and if the debtor did not pay off his debt before or at the fixed time, the creditor would ask the debtor, to affect a certain increase in the principal, in consideration of which the creditor would grant his extension in the time of repayment. Accordingly, many a times it so happened that if the actual principal loaned out was one hundred Dirhams, it was increased to two hundred. If again the debtor was unable to pay after the expiry of the extended period, a similar increase in addition to the principal is being made against the debtor. *This would go on for a number of periods*, with the result that the creditor receives double, treble or even four times the amount actually advanced."[15]

In his remarks, Qadi (Nasiru-din) Al-Baidawi, while commenting upon the above-mentioned verse (Qur'an III:130) stated that: "Taking double or treble interest means that, one should not increase the principal advanced double or treble and it is quite possible that the exact specification of (double and treble) might have been in contemplation of the custom prevailing. For these creditors demanded interest after fixing the period: then they would go on increasing to the principal in consideration of the time of extension allowed for repayment. This would be repeated to such an extent that the entire property of the debtor vanished on account of that petty loan borrowed."[16]

A number of islamic jurists of great repute tried to define Riba of the jahiliyyah.

according to **Imam Al-mujahid** (Died 104 after Hijra) "Riba of the Jahiliyyah which God has forbidden,was that, if a person owed a loan to another person he would say to him 'I would give you so much if you grant mean extension of time "[17]

According to Imam extension (Died 119 after hijra) says: "in the Jahiliyyah the Riba was that,when a person give a loan for a specified period and that period expired, the lender would ask the debtor Whether he would return the debt or increase the amount? If he made the payment it would be

accepted,otherwise the amount of the date would increase and the debtor allowed an extension"[18]

According to Imam Al-Tabari (Died 310 after hijra),while commenting on Riba verse in Suratul-Bakarah stated that:

> "a debtor is called 'MURB' because he doubles the amount of the debt. and in respect of the verse III:130 prohibiting the charging of double or fourfold interest, Kd says, on the Kd of Mujahid this was the Riba of the Jahiliyyah"[19]

Imam Yusif Al-Qaradawi, in his famous book 'HALAL WAL-HARAM FIL ISLAM: commenting on the verse IV:29 stated that, islam blocks the way for anyone who tries to increase his capital through lending on usury or interest [RIBA] weather it is at a low or at high rate. [pages 264-5]

The strict prohibition of interest in Islam is a result of it's deep concern for the moral, social and economic welfare of mankind.

Among the revealed religions Judaism prior to Islam had also prohibited interest in the old Testament the following has been stated:

"If you lend money to any of my people with you who is poor, you shall not be to him as a creditor, neither shall you require interest from him". (EXODUS 22:25)

In the Catholic Bible, Deuteronomy 19 RSV at page 172, the following has been stated:

"You shall not lend upon interest to your brother,interest on money: virtual interest on anything that is lent for interest. To a foreigner you may lend bless you in all that the LORD, your God may bless you in all that you undertake on the land which you are entering to take possession of".

According to Imam Abu Hamid Muhammad Al-Ghazali, the question of interest arises only in two cases in transaction of cash money, Gold and Silver and of foodstuffs. He asserted that interest occurs in these two cases only under two conditions.

1. If sale is hold on credit and not in cash that is, not to hand in hand transaction and

2. If more in quantity is taken in lieu of less quantity of the some kind of thing.

He further stated that, it is unlawful to sell a fixed

quantity of Gold or Silver for a fixed quantity of more gold or silver on credit. So also, it is not lawful to receive in cash the value of a certain thing, which is to be delivered in future. Here three things are to be observed in case of Gold and Silver.

a. Commercial coins in a great measure can not be taken in key of less quantity of pure coins. This kind of transaction is unlawful. And, an inferior quantity of a thing cannot, be taken in lieu of a good quantity of the same thing.

b. There is no fault in selling silvers to more quantity in lieu of gold of small quantity because they are of different kinds of things and not of the same kind.

c. If gold and silver are fixed and the quantity of each is not known, the transaction is not lawful.

In respect of FOODSTUFFS, Imam Al-Ghazali's view is that, when foodstuffs are of the same kinds it is lawful to exchange them and the rules of the same kind of thing, are applicable in this case.

2-3 THE POSITION OF INTEREST FROM PROPHETIC TRADITIONS

Furthermore, the justification over the prohibition of interest (RIBA) could also be viewed through the following prophetic traditions.

The prophet (S.A.W.) has condemned both the receiver and the giver of usury.(IMAM AL-BUKHARI)

It is related by Ibn.Mas'ud that, the prophet (S.A.W.) condemned the receiver, the giver of Riba and also the witness and scribe of the transaction: they are alike. (MUSLIM & TIRMIDHI).

It is related by Abbada b. Samit that the Messenger of Allah (S.A.W.) said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like of equal measure, handful for handful. If there is difference in kind, then sell as you please, if by handful then by handful". (IMAM BUKHARI & MUSLIM).

It is related by Abu Sa'id Al-Khudari (R.A.) that, the Messenger of Allah said: "Sell not gold for gold except in equal quantity, nor sell anything for the same thing in lesser quantity nor sell silver for silver except in equal quantity:

sell not anything for the same thing in lesser quantity: nor sell anything present for that which is absent". (IMAM AL-BUKHARI).

Abu Sa'id Al-Khudari (R.A) relates from Abu Huraira (R.A.) that, the prophet of God (S.A.W.) appointed a person Governor of Khaibar. He brought select dates to the prophet (S.A.W.), who asked: "Does Khaibar produce similar dates throughout the land?" He said, "No. By God, we purchase one Sa (measure) of this variety of dates in exchange for two sa's of another variety". Said the prophet (S.A.W.): "Do not do so (again); you should first sell these dates at the market rate for money and then purchase with that amount superior quality of dates". (IMAM AL-BUKHARI)

Malik Ibn. Aws (R.A.) narrates, "When I wanted to exchange one hundred dinar (Ashraffs). Talha B. Ubaid sent for me. Then we discuss the pros and cons of the transaction and reached at a settlement; he then took the gold into his possession and rose saying: "wait until my treasurer returns from the public market". Umar (R.A.) who was listening to this narration said: O Malik bn. Aws (R.A.), I beseech you in the Name of God (S.W.A.) that you should not leave Talha (R.A.) until you get from him the money, because the prophet (S.A.W.) has said: "Selling gold for silver, or date for date, is Riba, except when the exchange is from hand to

hand". (IMAM AL-BUKHARI & MUSLIM).

It is related by Uthman (R.A.) who said: The prophet (S.A.W.) said: "Do not sell one Dinar for two, nor one dirham for two". (IMAM AL-BUKHARI).

It is related by Umar (R.A.) who said: The prophet (S.A.W.) said: "To sell gold for gold, wheat for wheat, dates for dates and barley for barley is Riba except when the transaction is made from hand to hand (that is delivery is effected on the spot)".

Abu Sa'id (R.A.) says that one day Bilal (R.A.) came to the prophet (S.A.W.) with green variety of dates. The prophet (S.A.W.) enquired, "from where did you bring this?" Bilal said: "We had dates of inferior quality: we have therefore, given two sa's of that quality in exchange for one sa of this (superior) quality with the object of presenting it to the Noble prophet (S.A.W.). "On hearing this the prophet (S.A.W.) exclaimed: "A wa, A wa! (expression of condemnation). This is clear interest". Do not do so (again), rather, when you wish to acquire dates of superior quality first sell the dates of inferior variety for money, and then with the produce of the sale purchase dates of superior quality". (IMAM AL-BUKHARI).

Abu Sa'id Al-Khudari (R.A.) says: We usually received different varieties of dates. We sold two sa's of those varieties in exchange for one sa of a superior quality. The prophet (S.A.W.), thereupon enjoined upon us not to exchange two Sa'as for one sa not to exchange one dirham for two dirhams" (IMAM AL-BUKHARI).

In the said traditions above, there are two hypothetical cases of exchanging by measure not only silver and gold, but also other things;

Firstly, the thing which are the objects of exchange, belong to the same genus; for instance, silver for silver, barley for barley. Such transactions, in order to be lawfully effective demand that the commodities of exchange are of similar quality and that delivery is effected on the spot. In cases of credit or where the quantity of the objects of exchange differ; or when one of the two objects of exchange is missing - in all such cases the transaction is unlawful and prohibited.

Secondly, if both the objects of exchange are different for instance, gold for silver, or wheat for barley or two seers of dates in exchange for one seer of cheese or oil such transactions are lawful provided delivery is effected on the spot. Failing delivery on the spot, for instance to give

wheat today in exchange for barley to be given on the following day - this transaction amounts to interest.

In a nutshell, interest lies in exchanging commodities of the same kind (or genus) in varying quantities. If it is desired to acquire superior commodity in place of an inferior one of the same genus, it is necessary first that, that inferior commodity be sold in exchange for another commodity of a different kind and then with the commodity thus acquired, obtain the desired superior commodity. This will not amount to "interest" in so far as this latter exchange is between to different commodities altogether. Where the commodities of exchange differ in kind, it matters not if the quantities of exchange vary.

It should also be noted that, from the aforementioned traditions, Islam prohibited exchanging of Silver, Gold, Wheat, Barley dates or salt with a less or more quantities - which are of the same kind. However, this prohibition does not apply where the two commodities of exchange vary in kind, in such cases it is permissible to sell a smaller quantity of one commodity in exchange for a larger or even equal quantity of another commodity, provided always that the sale is not on credit and delivery of the commodities is effected on the spot.

One may be pertinent to ask, whether the above mentioned principle applies only to the six (6) commodities (ie Gold, Silver, Dates, Weath, Barley and Salt) which are specially mentioned or whether it applies to all. In respect of this there is difference of opinion between the Ulama.

According to one group Riba transaction applies only to these six (6) commodities mentioned in the traditions; While the second view of another group of Ulama is that, Riba regulation applies to all those commodities which are measured by measure or weight. Even in this case also there is difference of opinion amongst jurists, for instance, Shah Abdul-Haqq remarks in Ashi'atul-lomo'at that:

> "It must be carefully noted that these six (6) commodities alone are mentioned in tradition, although, jurists have extended the operation of the Riba regulations to other commodities by more analogous reasoning, for instance, all cereal coins. They have also tried to explain why they have extended the operation of Riba regulations to each one of the coins. But those who attach importance to the 'letters' of the law and who do not believe in 'analogy' consider Riba regulations not to others over and above these six.

However, this was a great fallacy on their part. The

In the Holy Quran-things of certain type are governed by certain principles from which a facit understanding or implication arises that matters which are analogous to those matters, concerning which the above-mentioned principles are also to be applied in those analogous cases. If, therefore, a principle is found in the Holy Quran, and another agreeing with it in the traditions, then it must, be taken for granted that the same meaning is implied in the Holy Qur'an (for traditions only clarify the ambiguities).

The Holy Qur'an declared interest unlawful while it was a custom of the pagans times that a later debt canceled the previous one only that creditor would say: 'the debt is discharged pay me my interest'. The prophet (S.A.W.) also illegalised this interest and said: "And the interest of the pagan times has been abolished".

Imam Al-Bukhari, while commenting on the verse (Qur'an II:278) which says:

"O you who believe! fear God, and give up what remains of your demand for usury, if you are indeed Believers") Ibn. Abbas said that this was the last verse which was revealed upon the prophet (S.A.W.). It is also related by Umar Ibn. Khattab (R.A.) who said: "The last to be revealed was the verse of usury and the prophet (S.A.W.) expired without

explanining it to us. Therefore give up usury or anything-resembling it". Because of the different opinions in respect of the last verse revealed to the prophet (S.A.W.). Muslim scholars have identify and attach certain verses, to be the last verse to be revealed in connection with individual injunction mentioned in the Holy Qur'an. So, with regards to the issue on RIBA, the verse (QUR'AN II:278) was the last verse revealed to the beloved prophet (S.A.W.).

Moreover, the prophet (S.A.W.) declared war on usury and those who deal in it, he pointed out it's dangers to the society saying:

> "When usury and fornication appear in a community the people of that community render themselves deserving of the punishment of Allah (S.A.W.)[xi].

It has come down from Jabir (R.A.) who said: The messenger of Allah (S.A.W.), cursed the devourer of usury as also it's giver the scribe of the deed and the witnesses to it and said: They are like (in the degree of sin). (IMAM MUSULIM)

From Abdullah b. Hanzalah, who was (on his death) washed by the Angles, who said that the Messenger of Allah (S.A.W.) said: A dirham which one consciously devours is thirty-six

(36) time worse than fornication. Baihaqi has narrated the same tradition in his Shubul-Imam from Ibn. Abbas, has added this much that the prophet (S.A.W.) said: "One whose flesh fattened on account of an unlawful thing he is most fitted for the fire. (IMAM AHMAD, DARUQAINI)

Also from Abu Huraira (R.A.) who said: the prophet (S.A.W.) said: "On the Night of Elevation, I passed by a people whose stomachs resembled houses full of snakes from which snakes could be seen coming out. I enquired who they were? Jibra'il said: There are devourers of usury". (IMAM AHMAD IBN. MAJAH).

Indeed, in another Hadith reported by Imam Ahmad, Abu Dawud, Al-Nisa'i, Ibn. Majah and Tirnidhi (who calls it sound Hadith) the prophet (S.A.W.) said:

"Allah has cursed the one who takes interest, the one who pays it, the one who writes the contract, and the one who witnesses the contract".

Nevertheless, more information regarding Al-Riba transactions could be found in TAFSIRS under the verses connected with Riba; but in respect of collections of traditions, this information is usually given under the caption "Kitabul Buyu" and Bubun-Riba".

2-4 THE POSITION OF INTEREST FROM THE HOLY QUR'AN

Islam's attitude to interest is clear and Unambiguous. The relevant verses of the Qur'an leave us in no IOTA of doubt about it. But, still the average Muslim, sandwiches as he is between the colossal ignorance of our Religious leaders and bewildering economic problems of the world, has very often lost his hold on Islamic principles as well as their economic implications.

The Holy Qur'an has laid down rather strict injunctions with regard to interest on money. These injunctions are repeated over with the same force and emphasis. It may be pointed out in the connection that the Qur'anic orders were first issued in a general manner, but fuller details were issued later. this was exactly the way in which commandments for Jihad were issued, that is stage after stage. This fact would become extremely clear if we compare closely (and scrutinize) the Meccan verses with those revealed at Medina keeping in view this principle of gradual or step by step revelation. It is thus clearly stated in the Holy Qur'an concerning the prohibition of interest.

1. Receiving interest is a peculiar characteristic of the Jews, who devour others property unlawfully. (see iv:160)

2. Thereafter Muslims were forbidden to receive compound interest: 'O you who believe do not devour compound interest' (see III:130).

3. After this has been accomplished the Divine Law - Giver thought it fit to prohibit all sorts of interest dealings. Allah (S.W.A.) permitted trading and forbidden usury.(see II:275).

It should be noted that, there is a consensus of opinion, both horizontally and vertically in terms of time among the Muslims that both the simple as well as the compound interest fell within the Qur'anic definition of Riba. Not as assume by few individual Muslims that simple interest is not the Qur'anic Riba. Absolutely, this view is not tenable. And any attempt to exclude simple interest from the ambit of Qur'anic Riba is a clear manifestation of spiritual suicide.

Despite the above, some Muslims still establish their argument based on suratul-Rum (xxx:39) in order to silence the prohibition of dealings in Riba. Absolutely these people are wrong. The verse which reads; "That which you lay out for increase through the property of (other) people, will have no increase with God. But that which you lay out for charity, seeking the countenance of God, (will increase): It is these who will get a recompense multiplied" (xxx:39) was revealed

before Hijrah. While suratul-Al-Imran (III:130) which states:

> "O you who believe! Devour not usury doubling and quadrupling..." was revealed in the third and fourth year of Hijrah.

Moreover, in suratul-Baqarah (II:275) it has a been stated categorically that:

> "Allah permits BAI (sale/trading) and forbid Riba (interest)", and also the subsequent verse of Al-Baqarah concerning Riba were revealed several years later during the last days of the Holy prophet (S.A.W.) after the conquest of Makkah. [71]

Hence, verse 275 of Al-Bagarah which clearly outlaws Riba takes the operational precedence over the previous verses, for being a latter revelation. This had been the general pattern of Qur'anic revelation about important matters that injunctions were given in a only stated that money laid at interest did not increase with Allah. Then the believers were told not to devour usury doubling and quadrupling. Thereafter distinction was drawn between BAI (trade) and RIBA (interest) and it's consequences were explained. Later Riba was made unlawful and the believers were commanded to give up what remained of Riba. Annually, a warning of painful chastisement

was given to those who continued to indulged in Riba.

The chronological order mentioned above is also confirmed by simple logic. The verse which clearly forbids Riba (interest) could not have been revealed before the verse which stated: "Devour not usury doubling, and quadrupling" as it would have meant that after forbidding Riba unconditionally the same was again permitted if it was not doubled or quadrupled. There is no doubt that Riba forbidden by Allah (S.W.A.) in respective of the fact whether it is simple or compound.

Let us now see what are those injunctions of the Holy Qur'an on this point. "Those who devour usury will not stand except as stands one whom the evil one by his touch hath driven to madness. That is because they say; Trade is like usury." But God hath permitted trade and forbidden usury. Those who after receiving
direction from their Lord, desist, shall be pardoned for the past, their case is for God (to judge): But those who repeat (the offence) are companions of the Fire; they will abide therein (forever)." Qur'an II:275 God will deprive usury of all blessing,but will give increase for deeds of charity for the loveth not creatures ungrateful and wicked." Qur'an II:276.

Later the Holy Qur'an has warned the swallowers of usury with

such a force and rigour that it is not be found in the case of other sins and fault. The words of the Holy Qur'an in this connection are characteristic:

"O you who believe! observe your duty to Allah (S.A.W.) and give up what remains of your demand for usury, if you are indeed believers." Qur'an II:278.

"If you do it not, take notice of War from God and His Apostle, but if you turn back, you shall have your capital sums, deal not unjustly and you shall not be dealt will unjustly." Qur'an II:279. However, "If the debtor is in difficulty, grant him time till it is easy for him to repay, but if you remit it by way of charity, that is best for you if you only knew." Chapter II:280.

Before the advent of Islam it was customary in Arabia to charge compound interest on all debts. The Holy Qur'an prohibited this practice in clear and unequivocal terms. For instance Allah (S.A.W.) stated:

> "O you who believe! Devour not usury, doubling and quadrupling (the sum lent): observe your duty to Allah (S.A.W.) that you may be successful." (Al-Imran II:130)

Moreover, it has been clearly pointed out that such

transactions will not elevate their financial condition, but will lead them to the same state to which the jews were led

> "for the inequity of the jews we made unlawful for them certain (foods) good and wholesome which had been lawful for them, in that they hindered many from God's way." "That they look usury though they were forbidden, and that they devoured men's substance wrongfully, we have prepared for those among-them who reject faith a grievous punishment." (iv:160 & 161)

Again in suratul - Run; it is stated:

> "That which you lay out for increase through the property of (other) people, will have no increase with God: But that which you lay out for charity, seeking the countenance of God, (will increase), it is these who will get is recompense multiplied) (xxx:39) Let us now examine the injunction of the Holy Qur'an where it categorically stated in chapter II:278-80. "O you who believe! fear God and give up what remains of your demand for usury, if you are indeed believers." If you do it not take notice of War from God and His Apostle, but if you turn back, you shall not be dealt with unjustly." "If a debtor is in a difficulty, grant him time till it is easy for him to repay but if you remit it by way of charity that is

best for you if you only knew."

From the above verse conclusion of fundamental nature can be drawn for elucidation purpose or for meeting a deficit in income and expenditure or whether the lender or borrower is an individual corporation or a government. Nevertheless, there is an indication in the verse 280 in chapter III that when the loan was contracted by the borrower the circumstances were not had. Now when the borrower is in want, the lender is being asked to allow him time and even being suggested to forego the debt by way of charity. Had the circumstances of the borrower been bad at the time of contracting, the loan the lender would have been asked to give the amount by way of charity instead of a loan. It proves that the prohibition of interest (being an addition in the principal sum) in a transaction of loan it is absolute and admit the exceptions.

"Here is a plain statement to Men of guidance and instruction to those who fear God." (III:138).

"Is the Man who follows the good pleasure of God like-the Man who draws on himself the wrath of God, and whose-abode is in Hell: A woeful refuge!" They are in varying grades in the sight of God, and God sees well all that they do." (III:162 & 163) God did confer a great favour on the believers when He sent among then an Apostle from among themselves, rehearsing into them the signs of God

sanctifying them unto them the signs and instructing them in scripture and wisdom while, before that they had been in manifest error." (III:164)

Some important doctrines in respect of verse on usury aught to be noted. Firstly, if one repents and turns back from dealings in riba, he is allowed to have his principal sum while he was asked to forego the amount of Riba that was owing. this by deduction defines Riba as any additional amount to the principal sum in a transaction of loan. Secondly and also dealings on this basis is a condition of really being a believer. the verse 278 in chapter II is address to the believers and ends with the words. "If you are really believers'" It highlights the sacrifices involved in foregoing the amount of interest owing and also the future dealing on interest which explains why it has been made a test for a being real believer. Thirdly, continuing dealings on the basis of interest amounts to provoking War from Allah and His Messenger.

And to be in a state of War from Allah and His Messenger and remaining a believer at the same time is not reconcilable. The two positions seen mutually exclusive. On this analogy many jurists consider dealings on interest a crime fit for capital punishment. Fourthly, the prohibition of interest is categorical and without any exception. And no distinction is

made as to whether the loan is contracted for a productive or for a consumption purpose.

1. RICARDO DAVID, Principles of Political Economy & Taxation.
2. MARSHALL, Principles - Eighth Edition, page 534.
3. KHUTDHIN SHMSF, Studies in Islamic Economics, page 64
4. Ibid at page 65
6. JOHN ROBINSON, Introduction to the Theory of Employment, page 13
7. GUSTAV CASSEL, Nature and Necessity of Interest. ANWAR IQBAL QURESHI, Islam and the Theory of Interest, Page 15-17.
8. N.W.SENIOR, Outlines of the Science of Political Economy, page 59.
9. Quoted by BOHM BAWHRK, Capital and Interest.

   ANWAR IQBAL QURESHI, Islam & the Theory of Interest, Chapter One.

10. BOHM BAWERK, Positive Theory of Capital; Smatt's Translation.
11. ANWAR IQBAL QURESHI, Islam and the Theory of Interest page 26.

    KUNT WICKSELL, Lectures on Political Economy

    KUNT WICKSELL, Lectures on Interest and Price.
12. BERTIL OHILY, Some Notes on the Stockholm Theory of Savings and Investment, Economic Journal, 1938.

13. LERNER, A.P.; Alternative Formulation of the Theory of Interest, Economic Journal, 1938.

M.A.MANNAN, Islamic Economic Theory and Practice, Chapter IX.

14. M.A.MANNAN, Islamic Economic Theory and Practice; Chapter VI, page 159.

15. ANWAR IQBAL QURESHI, Islam and the Theory of Interest, p.78.

16. Ibid, at page 79.

IMAM ABU HAMID MUHAMMAD AL-GHAZALI, ILYAULUM - id-deen Translated by Mautana Fazal-ul - karim, Book III chapter III (Earninus, Trade & Commerce) page 58.

ANWAR IQBAL QURESHI, Islam and the Theory or Interest; page 71.

IMAM AL-BUKHARI, Kitabul Bliyu (SAHIH AL-BUKHARI)

ANWAR IQBAL QURESHI, Islam a the theory of interest, chapter II

ANWAR IQBAL QURESHI, Islam in the theory of interest page 74-75.

20 Reported by Al-Hakim Abu Ya'ala reported something similar on good authority.

IMAM YUSUF QARADAWI, The lawful in the prohibited in Islam: page 264.
NAWAZISH ALI ZAIDI, Elimination of interest from Banks in Pakistan, page 258.

21 MUFIT MUHAMMAD SHAFI, Maarif Al-Qur'an and MAULANA MAUDOODI, Tafheem Al-Qur'an

2) BUKHARI, Kitabul-Buyu

CHAPTER THREE

3-1 CONCEPT DEFINITION

Riba/interest/or usury is defined as a fixed return for the use of money. And it is always prohibited whether it results from the "Loans of Gold and Silver" or economic credit the creature of modern banking and finance. In otherwords Riba is undue profit made, not in the way of legitimate trade, but of loans of Gold and Silver and necessary articles of food:- such as wheat, Barley, Dates and Salt (according to the list mentioned by the Holy Prophet (S.A.W.).[1]

It should be noted that Riba/or interest lies in exchanging commodities of the same kind (or genus) in varying quantities. If it is desired to acquire superior commodity in place of an inferior one of the same genus; it is necessary first, what, that inferior commodity be sold in exchange for another commodity of a different kind and then with the commodity thus acquired obtain the desired superior commodity. This will not amount to interest in so far as this latter exchange is between two different commodities altogether. And where the commodities of exchange differ in kind, it matters not if the quantities of exchange vary. In essence Islam prohibited exchanging of Silver, Gold, Wheat, Barley, Dates or Salt with a less or more quantities - which are of the same kind.

However, this prohibition does not apply where the two commodities of exchange vary in kind, in such cases it is permissible to sell a smaller quantity or even equal quantity in exchange for a larger or even equal quantity of another commodity, provided always that the sale is not on credit and delivery of the commodities is effected on the spot.

3-2 CLASSIFICATION OF RIBA

For the purpose of this, thesis two major types will be discuss here. And these are: (A) Riba Nasi'a and (B) Riba Fadl

(A) **RIBA NASI'A:** (Is the same with what was prevalent in the pagan time or days). It is a commercial transaction in which a creditor advanced a certain loan, on which he (ie. the creditor) exacted his interest every month and the initial principal and advanced remaining intact. Then after the expiry of the fixed time he would demand his dues from the debtors. If the latter were unable to pay, a certain additions is made to the principal in consideration of the "costing time" allowed for repayment. Of course, this is what is prevailing in the prevailing modern banking system. In fact, the above is contrary to the dictates of the Holy Qur'an where Allah (S.A.W.) said:

"If the debtor is in difficulty, grant him time till it is easy for him to repay, but if you remit by way of charity that is best for you if you only known. (II:280)

(B) **RIBA FADL:** This involves the exchange of the kinds or those kinds which resemble each other. In this respect, the debtor gives addition in kind, that is Weat for Wheat, Barley for Barley etc. It is related by Abu Said Al-Khudari that the Messenger of Allah (S.A.W.) said:

"Sell not Gold for gold except in equal quantity nor sell anything, nor sell silver for silver except in equal quantity: sell not anything for the same thing in lesser quantity nor sell anything present for that which is absent"[2] (IMAM AL-BUKHARI)

3-1-3 THE IMPLICATIONS OF RIBA/INTEREST

It is an established fact that interest - based loans not only cripple the borrowers but also demoralise the lenders because it lacks financial blessings spiritually. See Holy Qur'an chapter II verse 276 where Allah (S.A.W.) says:

"Allah will deprive usury of all Blessing .....". (II:276).

It is reported that, in India, a cultivator is born in debt, lives in debt and dies in debt".[1]

Sir Maclean Loya Darling in his book remarks that;

"The interest paid by the cultivators in the Punjab is twice the amount of the total and revenue payments. Comparing, the poverty of the punjab and the prosperity of the money-lenders, he observes that, in every village the best house usually belongs to the money-lenders".[4]

Nigeria is a shining example of the victims of the abomination of "Usury/Riba". The Nigerian economy has been caught in the debt trap of foreign creditors. The country was induced into the international borrowing or lending arena when the first. DUMBO Loan of U.S. ($1 billion) one billion Dollars was taken. Nevertheless the debt (which was only about U.S. $2 billion by October, 1979) had risen to U.S. $11 billion by 1983 and without any significant additional borrowing, the outstanding foreign debt against Nigeria has risen to over U.S. $35 billion in 1991. The cause for this being the tragic policy change which adopted debt Re-scheduling instead of debt repayment as the country's policy from 1984 to the end of 1985. And it should be noted that, debt Re-scheduling simply implied to periodic negotiation which always result in the

capitalization of unpaid interest charges and postponing the date for repayment to further periods in the future. The fate of this situation is perpetual poverty and economic bandage.

Most of the capitalist countries (in fact, all, with the exception of Japan) are ruled economically by the jews whose scheme when they perverted the true teachings of Prophet Musa (Alaihis-Salaam) was to lend to foreigners upon interest so that: ".....the Lord your God will bless you as He promised you, and you shall lend to many nations, but you shall not borrow, and you shall rule over many nations, but they shall not rule over you". The scheme of the Jews has succeeded and Nigerians as well many other people in the world are suffering the consequences of their rejection of the leadership that respected Allah (S.A.W.) saying that:

> "Allah hath cursed usury .....(II:276) as well as the following verse:
>
> "O you who believe! observe your duty to Allah, and give what remains from usury, if you are (in truth) believes." (II:278).
>
> "And if you do not, then be warned of War (against you) from Allah and His Messenger".

3-2 THE WISDOM BEHIND PROHIBITION OF RIBA

The strict prohibition of interest in Islam is a result of it's deep concern for the moral, social and economic welfare of mankind. Islam scholars have given sound arguments buttressing the rationale behind prohibition of interest.

In his Tafsir (of the Holy Qur'an) Imam Al-Razi have raise the following arguments; in respect of social, economic and moral aspect of life.

(A) **SOCIAL ASPECT:** In this aspect the lender is very likely to be wealthy and the borrower poor. If interest is allowed, the rich will exploit the poor, and this is against the spirit of mercy and charity.

(B) **ECONOMIC ASPECT:** In this context, the taking of interest could implied to appropriating another person's property without giving him anything in exchange, because one who lends one Dirham for two Dirhams get the extra Dirham for nothing. Now, a man's property is for (the purpose of) fulfilling his needs and it has great sanctity. According to a Hadith:

"A man's property is as sacred as his blood".[5]

This implies that taking it from him without giving him something in exchange is **haram.**

Nevertheless, people's efforts to work in order to earn money **is deterred** as a result of their dependence on interest. Since the person with Dirhams can earn in advance or at a later date without working for it. The value of the work will consequently be reduced in his estimation and he will not bother to take the trouble of running a business, or risking his money in trade or industry. However, this will lead to depriving people of benefits of marketing and the business world can not operate without industries, trade and commerce, building and construction, all of which need capital at risk.

(C) **MORAL ASPECT:** Imam Al-Razi argued that, permitting the taking of interest discourages people from doing good to one another, as is required by Islam. If interest is prohibited in a society, people will lead to each other with Goodwill expecting back no more than what they have loaned, while if interest is made permissible the needy person will be required to pay back more on loans (than he has borrowed) consequently, weakening his feelings of Goodwill and friendliness towards the lender.

3-3 THE PERMISSIBLE FORMS OF TRANSACTION

In disallowing interest and permitting profit, the shariah has developed some specific forms of business transactions. And for the purpose of this thesis we are to look into the most two common Islamic enterprise; viz: (i) V (ii) Musharaka. These are Islamic business oriented aimed at earning profit without charging interest; their details are discuss in the next chapter.

V traditionally has been applied to commercial activities of short duration. While Musharaka on the otherhand, is a form of business arrangement in which a number of partners pool their financial capital to undertake a commercial industrial enterprise of longer duration. The profit sharing arrangements may be applied either to the whole enterprise where each partner takes and equity position or to a particular line of activity within an enterprise, that is they can have either whole-firm or project specific orientation. In the Islamic profit sharing arrangement, while the profit is shared between the agent-enterpreneur and the owner of financial capital based on a predetermined share parameter, the financial loss is borne only by the owners of the funds and not the enterpreneur. Since human capital (as representative of present work and effort) in this arrangement shares equal status with financial capital (as representative

of X past labour and work) the agent enterpreneur losses his time effort and labour, but nothing more.

1. See chapter two for the prophetic traditions.

2. BUKHARI :Kitabul buyu

3. Report of the Royal Commission on DX. in India.

4. DARLING M.L., The punjab peasants in prosperity & debt, Oxford University Press.

5. Transmitted by Abu-Na'eem in Al-Hadith.

AL-FAKHAR AL-DEEN AL-RAZI, Tafsir Vol.7, page 4

CHAPTER FOUR

ISLAMIC ALTERNATIVE TO INTEREST

(MODARIBAH & MUSHARAKAH)

The areas of money, banking and investment are regarded as crucial to the process of Islamization of the economy. Modern banking, based on interest and biased in favour of the capitalists; and the rich and well to do, is rejected as un-Islamic because of the unequivocal prohibition of Riba by the Holy Quran (See Chapter II:275-279). And the consensus of Muslim Jurists interpreted it, as covering all kinds of interest, usurious or otherwise irrespective of the nature and function of the loan. Nevertheless, the Islamic emphasis on co-operation as the key concept in economic life has led to reliance on profit-sharing and participation as the alternative issues for banking and investments in-the Islamic framework.

4.1 CONCEPT DEFINITION OF MODARIBAH

Classically, Qirad or Muqarada is an arrangement in which one or more parties provide capital and the other party/or parties constitute their skills and labour. Profits are share in pre-agreed proportion of their capital contributions.

In otherwords, "It implies to a business in which a person

participates with his money and another with his efforts and skills or both his efforts and skills and shall include unit Trust and Mutual (funds by whatever name called".[1] In this respect the active partner is called Qarid because he is the one who travels and trade. "It is also possible that both the owner of the capital and the active partner are called **Mudarib** as both shared the profits with each other".[2] Historically, Madarabah or Qirad was widely practiced in the pre-Islamic era as a form of partnership. The Makkans were depending on commerce for their likelihood, and those who could not exercise commerce by themselves, travelling long distances and leaving their homes for long periods used to give capital to those able and willing to trade against a certain percentage of net profit.

1. NAWAZISH ALIU ZAIDI, Elimination of intetrest from banks in pakistan page 148
2. KHURSHID AHMAD, studies in islamic economics, page 60

4.2 QIRAD IN ISLAMIC - JURISPRUDENCE

Of the four well known schools of Islamic Jurisprudence the Malik and **Hambali** accept V as a variant form of SHIRKAH (i.e. partnership). The **Hannafi** Jurists also legitimized some from of V that bear close similarity to SHIRKAH in practice.

Shirkah (i.e. partnership) is used here in the sense of what the **Hannafi** Jurist term as Shirkat-Inan.[1] The **Hambali** and the **Shafi'i** Jurists also use the same term in this sense, while Jurists of the Maliki school use the term Shirkat-Mufawada to carry this meaning. for the purpose of our analysis, when we mentioned shirkah we mean the contract term shirkat-inan by Jurists of the **Hannafi** school and Shirkat-Mufawada by those belonging to the **Maliki** school.

However, Shirkah implies to the participation of two or more persons in a certain business with defined amounts of capital according to a contract for jointly carrying out a business and for sharing profit and less in specified proportions. It should be recall that, in mudarabah business one party provides capital and the other utilizes it for business

purpose under the agreement that profit from the business will be shared according to a specified preparation. And it is important to note that, under V the party that provides the Merchandise and the party that engage in business may each comprise many persons i.e. the capital may be provided by several persons and the business may be carried out by several other persons. Alternatively, capital may belong to one party and the party that utilizes it in business may be many or again, several persons may pool their capital while one person uses it for carrying on business. All these terms are considered as legitimate by the Shariah.[4]

Under Shirkah (i.e. partnership) it is not necessary for every party to enter into practical transaction, although none can be formally excluded from active participation. In principle, every party has the right to participate through in practice he may not.[5] And by mutual consensus it is possible that capital is provided by a few persons and the business carried out by one or more persons or that capital is provided by one person and business is carried out by many persons jointly, including the person providing the capital.

According to Zahiriyyah, Qirad compose of cash money, which is the capital. If the owner of the capital wants to give the active partner (**Al-Muqarid**) goods instead of cash money he must specifically ask him to first sell these goods and

utilize the proceeds of sale in this Qirad. **Ibn. Hazam** claims that there is unanimity on this view.

1. AL-KHAFFI, page 65: and his sources is from the Hannafi, Shafi'i and Hambali jurisprudence.

2. KASANI. Vol. 6 page 57

According to **Hannafi**, participation of the owner of the capital must be in coins, while they disagree about the validity of the contract if this participation is in non-minted Silver and Gold.

As for going goods as participation, they claim that his vitiates the Qirad and makes it void.

Hanbalites and **Shafi'ites** are of the opinion that participation must be by means of a definite amount of minted coins, while the contract is vitiated if participation takes the shape of either non-minted gold and silver or any other goods.

Malikites are divided among themselves about the validity of goods as capital for Qirad/V, some agree and some object.

Ibn. Qudamah, an eminent exponent, states that:

> "Qirad is valid if the sale scribe capital is determined, whether it is coined or precious metals or goods".

He supports his view by the views of **Abu-Bikr, Abu al-Khattab,** Malik **Ibn. Abi Layla, Tawus, Imam Al-Awza'i and Ibn.Abi Suleman.** These justify their opinion on the plea that:

> "the main objective of V which is a sort of association, is that both parties dispose of both capital and labour and participate in the profit earned by the partnership. And such profit-Sharing takes place whether the capital is in money or goods".

The idea behind forbidding Qirad unless the participated capital is in coins, gold and silver is that, the trading capital must be unequivocally determined so that every partner can assess his share in profits in accordance with his participation in the partnership. This is quite an acceptable logic, it was adopted by those who allowed goods as capital, provided that the owner of the capital asks his partner to sell the goods, determines their price and uses the some as capital.

According to **Imam Al-Shawkani**, Qirad is one form of association where all sorts of participation are allowed. Consequently, if any one claims that the prescribed capital in Qirad can only be in cash money he must produce evidence to support his claim. **Al-Shawkani** came to the same conclusion, i.e. any goods if determined value can be subscribed as capital in V. He, however, based his judgement mainly on the **Salih Hadith**, quoted in **Al-Bukhari** on the authority of **Jabir ibn. Abdullah** where the **Prophet (S.A.W)** sent on expedition of 300 soldiers under the command of **Abu Ubaidah Ibn. Al-Jarrah** in the direction of the sea-share. I was one among them. On our way, the expedition's supplies were exhausted. **Abu Ubaidah** gave an order to collect all supplies with the soldiers which supplies totalled two Mizwad's of dates. He stated rationing them among us till they came almost to an end and he began distributing them one by one. I asked him what one date could help and he answered that it was something instead of nothing".

(Imam Al-Bukhari) Imam Al-Shawkani also referred implicitly to **'Asha'arriyyin Hadith'** where the **Holy Prophet (S.A.W)** said:

> "If the Asha'arriyin went far for conquest or if their fortunes in Medina dwindled, they amused whatever they had in one bag and divided it equally among them, so they belong to me and belong to

them".

In his personal opinion **Imam Al-Shawkani** stated that, the analogy is relevant because Qirad is different than such benevolent voluntary cooperation. In this respect, he remarks that, these is no act if agreement between capital and labour to enter into partnership for yam, and the objective is quite different. In essence, the whole idea of any gain or trading association is completely absent in the aforementioned Hadith.

There is also a different of opinion about whether the acts of V would be valid or not if the Mudarib or the active party subscribed any amount of money (or goods) over and above the subscription or the capitalist (i.e. the owner of the capital).

In his views the author of "studies in Islamic Economics, Khurshid Ahmadu stated that; the essence of Qirad is that the capitalist enters into association with an active partner in an enterprise whereby the first gets a share if the profits (positive or negative) earned by the capital of the first and the work of the second. So there is nothing that stands against contributing capital goods or in precious metals, as long as the value of goods is well determined at the time of concluding the act of Qirad. Nor is it against any Islamic rule that the Mudarib would subscribe a fixed amount of

capital (again in money or in goods) in which case he would naturally be entitled to a higher stake in the partnership.

4.3 MODARIBAH IN THE HOLY QURAN AND SUNNAH

Modaribah or Qirad is not mentioned in the Holy Quran by name. However, the verses legitimizing or recommending economic activities in general and trade in particular covers V by implication. Attention is especially drawn to the following verses:

> "O you who believe! Eat not up your property among yourselves in vanities; but there is among you traffic and trade by mutual goodwill. Nor kill (or destroy) yourselves; for verify God hath been to you Most Merciful!"
>
> (IV:29)

Likewise in the suratul-Bagarah **(Quran II:275)** the Holy Quran stated:

> "..... But God hath permitted trade and forbidden usury". "It is no crime in you if you seek of the bounty of your lord (during pilgrimage)" . II:198[6]

Since trade is for profit, legitimizing trade means legitimizing profit. If it is legitimate to earn a profit, it should also be legitimate to earn a share out of it. Income through trade and industry is included in the meaning of the term bounty (FADL) in the following verses:

> ..... others travelling through the land, seeking of God's bounty"
>
> (LXXIII:20 i.e. 73:20)

Hence, men are exalted to co-operate for good cause, and profit-sharing appears to be well-qualified in this regard **(Al-Ahlawi Vol.2 Page 116)** that brings Modaraba within the purview of verse 11 in the Suratul-Ma'idah (V:2).

Profit-sharing between the superior of money capital and the one actually using it in business was being practiced in Arabia and elsewhere in the eve of Islam. The Prophet (S.A.W.) endorsed this practice. He had personally engaged in it before he attained Prophethood [7] And this practice continued after the Prophet (S.A.W)[8]. More relevant traditions and precedents are quoted below:

The Prophet (S.A.W) had entered into a partnership with Sa'id at Makkah. When he met him at Medina he recollected the incident and mentioned it with approval. (See Al-Sarakhsi

Vol.II page 151).

It is reported from the Prophet (S.A.W) that God (S.W.A) affirms that until one of the two parties breaks the trust, I remain their third partner. (See ABU-DAWUD'S SUNAN; Kitabul-Buyu Babu shirkah). The same tradition has also been reported by HAKIM and BAIHAQI, also one can refer to Al-Madani.

It is also reported that, a man came to the Holy Prophet (S.A.W.) and said:

> "I work at the market and my partner engages himself in prayers in the Mosque: The Prophet (S.A.W.) remarked, 'probably the prosperity of your business is due to his fact'.[9]
> The Prophet (S.A.W.) is reported to have said:
>
> "That Man who is bringing up three daughters i like a prisoner; O slaves of Allah, do Modaribah with that Man, lend him' [10]
> Uthman practiced Modaribah (See AL-SARAKHSI Vol.2 Page 18).

Abbas bn.Abdul-Muttalib (R.A.) engaged in Mudarabah, deals with certain conditions when the Holy Prophet (S.A.W) came to know of it, he expressed his approval.[11]

Hakim ibn. Hizam (R.A.) was also engaged in Modaribah with the same conditions.[17]

Abu Na'im reports that the prophet before attaining prophethood went to Syria for trade with Khadiza's merchandize on the basis of profit-sharing : (See AL-KHAFIF).

Ibn, Majah reports the Prophet (S.A.W) to have remarked:

"prosperity lies in Modaribah".

(See Al-Khafif)

Qasim bn. Muhammad reports that we had deposited some of our savings with **Aisha (R.A.)** who lent-them out on Modaraba for business purposes. Likewise **Umar (R.A.)** concluded a Modaribah contract with **Zaid bn. Khulaida** and has also concluded a Modaribah contract on behalf of the **Baitul-Mal** (See IMAM EXTENSION, Kitabul Qirad). It is also reported of him that he gave out the saving of the orphans on Modaraba for business purposes in order that these savings might grow. (See Al-SARAKHSI Vol.22 P.18)

4.3.1 MODARIBAH IN ISLAMIC HISTORY

Profit-sharing continued to be practiced throughout Islamic history. This is evidenced by the fact that all the compendiums of Islamic law compiled during the second century

onwards, till date, denote a section or chapter to Modaribah or Qirad along with other forms of sharing. Historians home recorded numerous instances of Modaribah contracts, some are given below:

The renowned scholar Sheikh Safyan Al-Thauri (Died 126 after Hijrah) traveled to Yemen with four thousands Dinars (4,000 Dinars) on V basis (see Al-Dhauabi: Vol.7 page 277).

During the reign of **Abbasid**, caliph Mansur (136-155 after Hijrah), a man named **Yasar bn. Mahduj** entered into Modaribah with his brother-in-law, Siraj, and made a business trip to china, making good profits. (See Waki:Vol.2 Pages 81-82).

Dalaj (Died 351 after Hijrah) a noted scholar as well as a prosperous trader of Baghadad owned much of his prosperity of money given to him on Modaribah basis by another businessman, (See AL-DHAHABI, Vol.16, page 341).

1. NAWAZISH ALI ZAIDI, Elimination of interest from Banks in Pakistan Page 148.
2. KHURSHID AHMAD, Studies in Islamic Economics, Page 60.
3. Kasani, Vol.6 Page, 57.
4. AL-KHAFFI, Page 65: and his sources is from Hanafi,

Maliki, Shafi'i and Hambali Jurisprudence.

5. AL-KHAFFI, pages 42-44: and his sources is from Hanafi, Maliki, Shafi'i and Hambali Jurisprudence.

6. See Appendix 219 for Commentary in the Glorious Qur'an by: ABDULLAHI YUSUF ALI.

7 IBN-HISHAM: Pages 187-88 and AL-ZARQANI; Vol.3, Page 345 and ZARAKHSI; Vol.22, Page 18-19.

8. IMAM EXTENSION: Kitabul-Qirad, IBN. SA'ID; Vol.3 Page 60. AL-BAIHAQI; Vol.6, Page 3 and AL-SHAUKANI; Vol.3 Page 282.

9. AL-SARAKHIS Vol.22, page 18.

10. Ibid at page 19.

11. AL-SARAKHSI: Vol.22, Page 18

12. Ibid at page 19.

CHAPTER FIVE

DATA PRESENTATION AND ANALYSIS

ISLAMIC BANKING: A GLOBAL MOVEMENT

The establishment of Islamic development bank led the way for introducing Islamic principles in commercial banking and a few institutions based on these principles were set up during 1977. As a tribute to his role in establishing the islamic development bank some of Islamic banks were named after King Faisal. These includes the Islamic bank of Jordan, Islamic bank of sudan, Faisal Islamic bank of Egypt, Kuwait Finance House, the Islamic bank of Bahrain and Dubai Islamic bank.

Nevertheless, for the purpose of this project the researcher is to consider Pakistan and the Islamic Republic of Iran as a case study.

5.1 ISLAMIZATION OF BANKS IN PAKISTAN

On September 23, 1977 the President of Pakistan entrusted council of Islamic idealogy with the tasks of preparing a blue-point for an interest-free economic system. In November 1977 the Council appointed a panel of economists and Bankers for compiling their recommendations in the sphere. The banker members of the panel were assigned with the job of drafting

interest-free commercial banking framework and this sub-committee completed its report on January 2, 1978. The panel presented its final report to the council of Islamic ideology in February 1980 and with some modifications and substitution the council adopted this report on June 15, 1980.

For initiating the process of interest-free banking in the Nationalised commercial banks, the Pakistan Banking Council constituted a "Superior Taskforce" for devising the necessary procedures required for the implementation of interest free banking. The Task Force submitted its reports on August 4, 1980. After these preparations and as a first step towards elimination of Riba from the banking system, beginning first January, 1981, all the 7,000 branches of the Nationalised commercial banks in Pakistan started accepting deposits on the basis of profit and loss sharing (P.L.S) The utilization of P.L.S. deposits has been authorized by state Bank of Pakistan from time to time in the following Assets:

I. As from January, 1981 (Ref. State Bank of Pakistan Banking control department circular No.26 of December 24, 1980)

   (a) Financing of commodity operations of the Federal and Provincial Governments and their Agencies.

(b) Export bills purchased/negotiated under letters of Credit, (other-than those under reserve).

(c) Investment in shares participation Term certificates and PLS based transactions.

(d) Provision of finance to House Building finance corporation.

II. From March 1, 1981 (Reference SBP-BCD circular No.26 of December 24, 1980)

(a) Documentary Inland Bills drawn against letters of Credit Purchased/Discounted.

(b) Financing of trading operations of:

i) Rice export corporation of Pakistan.

ii) Cotton export corporation.

iii) Trading corporation of Pakistan.

(c) Import bills drawn under letters of credit.

III. As from November 2, 1982 (Reference SBP-BCD Circular No.37 of November 2, 1982).

(a) Musharkan (profit and loss sharing)

(b) Leasing

(c) Hire purchase

IV. As from November 2, 1982 (Reference SBP-BCD circular No.37 of November 2, 1982).

(a) Investment in Modaribah certificate

V. As from July, 1984 (Reference SBP-BCD circular No.13 of June 20, 1984).

(a) **Financing by lending**

i) Loans not carrying any interest on which the banks may receive a service charge not exceeding the proportionate cost of the operation, excluding the cost of funds and provision for bad and doubtful debts. The maximum service charge permissible to each bank will be determined by the state bank from time to time.

ii) "Qard-e-Hasan" loans given on compassionate grounds free of any

interest or service charge and repayable if and when the borrower is able to pay.

(b) **Trade Related Modes of financing**

i) Purchase of goods by banks and their sale to clients of appropriate mark-up in price on deferred payment basis. In case od default, there should be no mark-up on mark-up.

ii) Purchase of trade bills.

iii) Purchase of moveable or immovable property by the banks from their clients with Buy-Bank Assessment or otherwise.

iv) Leasing

v) Hire-purchase

vi) Financing for development of property on the basis of dent charges.

(c) **Investment type modes of financing**

i) Musharaka or profit and loss sharing.

ii) Equity participation and purchase of shares.

iii) Purchase of participation term certificates and V certificate.

iv) Rent sharing.

The State Bank of Pakistan specifies ranges of profit that should guide banks and the specialized credit institutions in their lending operations under both trade-related and investment type mode of financing. Estimated rates of profitability arising out of different modes serve as a basis for determining these ranges. Table I below summarizes these ranges as they apply at present.

TABLE I

PAKISTAN: RANGES OF PROFIT ON TRADE-RELATION AND INVESTMENT-TYPE MODE OF FINANCING

	RANK OF PROFITS	
	MINIMUM	MAXIMUM
For exports under the Export		
Finance Scheme	-	6.0%
Financing under the Scheme for financing locally manufactured machinery: Local Sales		
Export Sales	-	7.5%
Preshipment stage	-	6.0%
Pastshipment stage	7.0%	NO MAX.
All other, not specified elsewhere		
Trade-related finance	10.0%	20.0%
Investment-related finance	10.0%	NO MAX.

Sources: State Bank of Pakistan, BCD circular No.23, and BCD Circular No.24 (Mary 25, 1985).

In principle, profits earned by a bank should not (actual profits of the client permitting) be less than the specified minimum profit. Should less occur, they are to be share by all the financiers in proportion to the respective amounts provided by them. In the case of trade-related modes of financing, there cannot be a compounding of overdue profit, mark-up, or service charge. Under the interest-based system, ceiling rates were specified for a wide variety of loan operations, under the new system considerable flexibility is given to the banks and their clients. Despite this flexibility, a large proportion of financing, according to banks, has so far been provided at about the same cost as under the previous system.

EXPERIENCE

It is too early to assess fully the impact of the new system on the operation of banks, in particular, and the economy, in general. For instance, detailed data are not yet available on the shifts in banks asset liability structure. Profit and loss-sharing deposits have grown sharply since their inception in 1981 and at the end of June 1985 stood at PR 38 billion, or the equivalent of 28% of total deposits (See TABLE II below); effective July 1, 1985, all deposits were converted to a non-interest basis.

TABLE II

PAKISTAN: GROWTH OF PROFIT AND LOSS-SHARING DEPOSITS, 1981-85

(In Billions of rupees)

	End December			End June		
	1981	1982	1983	1984	1984	I985
Total deposits	70.0%	82.8%	106.9%	111.7%	117.9	138.0
Return-bearing deposits	54.7%	66.4%	86.3%	91.0%	98.0%	--
PLS deposits	6.5%	12.9%	19.9%	29.7%	22.1%	38.1%
PLS deposit/total deposit (in %)	9.2%	15.4%	18.6%	26.3%	18.7%	27.6%
PLS deposit/return bearing deposit (in %)	11.9%	19.4%	23.1%	32.3%	22.6%	-

Sources: Data supplied by the authorities; State Bank of Pakistan, Monthly Bulletin (November 19985); and State Bank of Pakistan, Annual Report, 1984/85.

Time PLS deposits rose faster than demand deposits, accounting for 65% of total PLS deposits at the end of June 1985. Moreover, most PLS deposits up to the time of compulsory conversion to a PLS basis were personal deposits. Data on the use of PLS funds, available only for 1984, indicate that PLS deposits were not fully utilized under the non-interest based modes of financing (See TABLE III below).

TABLE III

PAKISTAN: INVESTMENT OF PROFIT AND LOSS-SHARING FUNDS BY COMMERCIAL BANKS, 1984.

	JUNE 1984		DEC. 1984	
	VALUE	SHARE	VALUE	SHARE
	(In Millions of Rupees)	(In %)	(In Millions of Rupees)	(In %)
Mark-up & Mark down	17,318	86.7	16,263	83.0
Commodity Operations	14,687	73.6	11,426	58.3
Trading Operations	727	3.6	2,755	14.1
Documentary Inland Bills	298	1.5	377	1.9
Export bills	705	3.5	953	4.9
Import bills	901	4.5	613	3.2
Others	--	--	139	0.7
Musharaka	617	3.1	777	4.0
Hire-purchase	132	0.7	130	0.7
Rent sharing (housing loans)	130	0.6	198	1.0
Investment (Equity Participation)	1,593	8.0	1,970	10.1
Others	176	0.9	249	1.3
TOTAL	19,967	100.0	19,587	100.0
Memorandum Items:				
Total PLS, deposits	22,088	------	29,684	-----
PLS Financing/PLS deposits (in%)	------	90.4	------	66.0
Total bank credit and investments	140,206	------	147,928	-----
PLS Financing/total bank credit & investments (in %)		14.2		13.2

Sources: Data supplied by the authorities, Government of Pakistan, Annual Economic Survey (1984-85) and the state Bank of Pakistan, Monthly Bulletin (November 1985). NB: The above

data cover only nationalized banks, which account for over 90% of the total banking sector's assets and liabilities.

Nevertheless, PLS investments accounted for about 13% of total bank credit and investment at the end of 1984. Over 80% of such investment were, however, short term and were undertaken on the basis of mark-up and mark-down methods of financing. Equity participation and Musharaka accounted for less than 15% of the total, owing in part to a lack of appropriate institutional and legal infrastructure, experience, and trained staff needed to evaluate projects, requiring participation by the banks. In view of the predominance of the short-term mark-up based operations, bank managements did not encounter serious adjustments difficulties; the basis for banking operations is still the bankers knowledge of their clients and familiarity with their credit-worthiness, rather than the expected profitability of the activity for which financing is sought.

5.2 IMPACT ON MONETARY POLICY AND BANK REGULATION

Monetary policy in Pakistan is characterised by direct and selective control of growth and distribution of domestic credit Annual Plans and specific credit targets are formulated on the basis of the objectives of the annual development programme. In this respect, credit is allocated to government and non-government sectors on the basis of annual credit plans. given the predominance of direct controls on the creation and allocation of credit, little use is made of indirect instruments to regulate credit expansion.

The minimum cash reserve requirements and liquidity ratios for banks are utilized primarily for prudential purposes. Since bank borrowing from the State Bank of Pakistan has, in general, been restricted to certain specific refinancing facilities; the use of rediscount rate policy of the bank(state) of Pakistan has been limited. and it should be noted that accordingly, the bank rate has not been changed since June 1977.

The evolution of the banking system since the implementation of non-interest banking has not necessitated changes in procedures and regulations governing bank supervision. Most

bank transactions continue to be short term and are based on mark-up rather than on taking long-term equity positions. The risk exposure of banks has therefore remained virtually unchanged. Hence, it has not been necessary to alter liquidity and cash reserve requirements. Procedures for dealing with delays in repayment and delinquent loans, however, have been changed. It could be recalled that under the former system, banks could impose interest on interest when there were delays in payments. The new system does not permit assessing mark-up on mark-up in the event of delays in payments. Instead, a system of fines for late payments in effect imposed by twelve(12) banking tribunals, which must render their decisions within four months. The banks have been encouraged to develop their own procedures to implement broad guidelines issued by the State Bank of Pakistan. Since most of the transactions are on a mark-up basis, the banks have had little difficulty in accommodating their existing procedures. However, it is recognized that any further transformation of the system requiring a shift in lending toward equity participation would require more substantial charges in procedures and the acquisition of skills for designing and monitoring such operations.

A comparison of the interest rate and rates of return offered by banks on PLS deposits prevailing prior to Islamization shows that the returns on PLS deposits have been generally higher (SEE TABLE IV below).

TABLE IV

'EREST RATES AND RATES OF RETURN UNDER PROFIT-AND-LOSS-SHARING FROM 1981-85

;its		Savings		Six Month		One-Year		Two-Year		Three-Year		Four-Year		Five & abo\
) Days		Deposits		Deposits		Deposits		Deposits		Deposits		Deposits		Deposits
Non		Non		Non		Non		Non		Non		Non		Non
'LS	PLS	PLS	PLS	PLS	PLS	PLS	PLS	PLS	PLS	PLS	PLS	PLS	PLS	PLS
-	-	7.6	8.6	9.4	10.9	10.4	12.2	10.5	12.7	11.2	13.7	12.0	14.2	12.0
-	-	7.6	8.7	10.0	11.2	10.2	12.5	10.6	13.0	11.3	13.9	12.2	14.4	12.2
-	-	7.6	8.6	9.8	10.8	10.3	12.0	11.1	12.7	12.0	13.6	12.3	14.1	12.4
-	-	7.6	8.2	9.9	10.5	10.6	11.5	11.0	12.1	12.0	13.1	12.2	14.0	12.5
-	-	7.6	8.3	9.9	10.5	10.5	11.6	10.8	12.2	11.8	13.0	12.4	13.6	12.4
-	-	7.6	7.7	9.9	9.9	10.5	10.8	10.7	11.5	11.7	12.3	12.4	12.8	12.4
6.5	-	7.6	7.5	9.9	9.5	10.5	10.5	11.1	11.0	11.8	11.8	12.5	12.5	12.5
6.5	6.9	7.5	8.0	9.5	10.1	10.5	11.2	11.0	11.8	11.8	12.5	12.3	13.1	12.8
-	6.2	-	8.3	-	10.8	-	11.1	-	12.2	-	13.2	-	14.2	-

he Authorities; and the State Bank of Pakistan, Monthly Bulletin (May 1985).

In respect of the above table, the rates of return offered by banks have shown variances of up to 10% Although no data are available on shifts in the size and maturity composition of individual banks liabilities, differences in their rates of return may have generated transfer, of funds among banks, thus encouraging competition. And to protect the interest of both borrowers and lenders and to ensure a smooth transition from the highly regulated interest based system to market-oriented financing the state bank of Pakistan is empowered to establish ranges within which financial institutions, including banks and the specialized credit institutions, and borrowers would be permitted to negotiate rates of charges and profit-sharing ratios.

The determination of these ranges is also guided by consideration releting to sectoral credit allocation priorities and the need to minimize dislocations arising out of a sharp change in the cost of funding for borrowers. Hence, the concern so far has been to keep the costs of funding as close to those prevailing under the interest-based-system as possible, while allowing market faces a greater role.

ISLAMIZATION OF BANKS IN THE ISLAMIC REPUBLIC OF IRAN

Following the Islamic revolution in 1979, the Iranian authorities took steps to bring the banking system operations into correspondence with the requirements of Islamic Law. In February 1981, certain administrative steps were taken by Bank Markazi (i.e. the Central bank of Iran) to eliminate interest from banking operations, as a result, interest on all asset-side transactions was replaced by a 4% maximum service charge and by a 4% to 89% minimum "profit" rate depending on the type of economic activity. Interest on the deposit was also converted into a "guaranteed minimum profit.

In the meantime, preparations got under way for the submission of comprehensive legislation to bring the operations of the entire banking system into compliance with the Sharia. The legislation, prepared by a high level commission (which composed of religious specialists, bankers, academics and businessmen) was passed by the parliament in August 1983 as the law for Usury-Free Banking.

According to the new law, liabilities acquired by the banks must be based upon two kinds of transaction.

(A) **QARD AL HASANAH DEPOSITS**

In the context of the law, Qard al-hasana constitutes current and savings deposits (as in the conventional banking system) except that they earn no returns. The banks can, however, offer incentives to attract such sayings deposits and can include one or all of the following: non fixed prices and bonuses in cash or in kind; an exemption from, or a discount in the payment of commission and fees and priority in use of banking facilities. The purpose of these accounts, from the point of view of the customers, would be to serve as a means of transaction, payment and liquidity. Moreover, the banks are to consider these deposits (both current and savings) as their own resources in their utilization, but no profits are to be passed on to the depositors.

(B) **TERM INVESTMENT DEPOSITS**

In this respect, banks are authorized to accept two types of investment deposits, short-term and long-term. The deposits differ with respect to the minimum required time limits, three months for short-term and one year for long-term deposits, and with respect to the minimum amount required: RLS. 2,000 for short-term and RLS.50,000 for long-term accounts. The law provides various modes of operation upon which the financing transactions of the bank must be based. These are:

(i) ***PARTNERSHIP (MUSHARAKAH):***

This form of enterprise recognizes two modes viz; civil and legal.

Civil Partnership: This is a project specific partnership of short duration in commercial production, and service activities in which each partner provides a share

of the necessary capital, and the assets and properties thus acquired are held as community property until the end of the life of the partnership. In these cases, the banks share in the partnership cannot exceed the share of the manager -enterepreneur initiating or directing the project.

Legal Partnership: Is a firm specific venture of longer duration in which the bank provides a portion of the total equity of a newly established firm buys into an existing corporation. The banks can take equity positions in such partnerships only after the technical economic and financial viability of the firm (or the project) has been appraised and the minimum expected rate of return from investment is deemed high enough to warrant such actions by the bank.

DIRECT INVESTMENT: In any economic activities, banks can undertake to invest directly by choosing; so long as the following requirements are met:

i) Banks cannot undertake to invest directly in projects in conjunction with the private sector and in projects that lead to the production of luxury and unnecessary commodities.

ii) The ratio of the initial capital of these ventures to total funds needed must not be less than 40%.

iii) The total fixed capital necessary for undertaking these projects must be provided for by long-term financial resources.

iv) Undertakings of direct investment by banks must be based on well-documented evaluation and appraisal of the project; and use of bank resources and investment deposits in direct investment projects is allowed if, and only if, the expected return from these projects is sufficient to meet the minimum required rate designated by the Bank Markazi (i.e. the Central bank of Iran).

v) Banks must report to the Bank Markazi the amount of their own, as well as depositors, resources allocated to direct investment projects.

vi) Once the projects in which the banks have directly invested have begun their productive activity, banks can sell shares to the public.

vii) Bank Markazi is authorized to investigate and audit direct investment projects in which banks have invested.

V: This is a short-term commercial transaction. It is a contractual partnership between a bank and an agent-entrepreneur according to which financial capital is provided by the bank and managerial effort by the entrepreneur in order to undertake a specific commercial project. In this respect, it should be noted that, banks are not allowed to engage in V financing of imports with the private sector.

SALAF TRANSACTION: To provide firms with the needed working capital bank can prepurchase their future output as long as the product characteristics and specifications are determined at the time of the purchase and the agreed price does not exceed the market price of the product at the time of the transaction. Banks however, cannot sell the product until they have taken physical possession of the same. And the delivery date of the product which is to be established at the time of the transaction cannot exceed one, production cycle or one year, which ever is shorter.

INSTALMENT PURCHASES: Banks are authorised to purchase raw materials, machinery and equipment for firms and resell the same to them on instalment. And the quantity of the raw materials can not exceed that necessary for one production cycle and the repayment period for the same cannot exceed one year. Consequently, the price of the product subject to the transaction is to be determined on a cost-plus basis. It should also be noted that, the repayment period for machinery and equipment cannot exceed their useful life, which is considered to begin on the date of their utilization in the production process and the duration of which will be determined by the central bank. Nevertheless, residential housing can also be built and sold by banks on instalmental basic

LEASE-PURCHASE TRANSACTION: Banks can purchase the needed machinery and equipment, or other movable and immovable, property, and lease the same to firms. At the time the contract is entered into, firms have to guarantee to take possession of such property at the end of the contract period, if the conditions of the contract are fulfilled. The time period involved in this transaction cannot exceed the useful life of the property (to be determined by Bank Markazi) Banks however, cannot engage in transactions in which the useful life of the subject property is less than two years.

JU-ALAH (TRANSACTIONS BASED ON COMMISSION): Banks may provide or acquired services whenever they are needed and charge or pay commissions or less for such services. The services to be perfomed and the fee to be charged must be determined at the time of the transaction.

MUZARA'AH: Banks may provide agricultural lands that they own or are otherwise in their possession (e.g. as a trust) to farmers for cultivation for a specific period and a predetermined share of the harvest. However, banks may also provide seed and fertilizer along with the land if they so choose.

MUSAQAT: Similarly banks may provide orchards or trees that they own or that are otherwise in their possession (e.g. as a trust) to farmers for a specific period of time and a predetermined share of the harvest.

QARD AL-HASANAH LOANS: Banks are required to set aside a portion of their own resources in order to extend interest-free loans to the followings:

i) Small producers, entreprenurs, and farmers who would otherwise be unable to find alternative sources of financing investment and working capital.

ii) Needy customers. Banks are permitted to charge a minimum service fee to cover the cost of administering these loans.

Nevertheless banks are permitted to purchase debt instruments of less than one year's maturity, but only if the debts are issued against real assets.

GENERAL REGULATION GOVERNING ASSETS ACQUISITION BY BANKS IN IRAN

The Law for Usury-free banking has not only provides regulations to cover specific modes of transactions but also specifies additional regulations that govern asset acquisition by the banks. The most vital are as follows:

i) Banks can only extend credits when they are reasonably assured that the principal sum granted and resulting profits are returned within a specific period of time.

ii) Banks are responsible for the control and supervision of the activity to which their own resources and/or the resources of their depositors are contractually committed.

iii) Credit can be extended, conditional upon observance of proper procedures that ensure the security of the financial resources extended by the banks.

iv) Banks must ensure that the value of physical assets obtained through the use of their resources by their clients and the value of collateral is, at all times equal to the remainder of outstanding principal. To this end, banks may take steps to ensure the value of such assets or collateral during the lifetime of the project.

v) While banks may engage in joint venture projects with other banks, one specific bank must assume the responsibility of supervision and control of the project undertaken.

vi) Banks must take necessary steps to ensure that their clients understand that contracts mutually consented to are binding legal documents and will be treated

as by the courts.

SUPERVISION OF THE BANKING SYSTEM

The Law has placed the responsibility of the supervision of the banking system of the country with Bank Markazi and accordingly it has specified the following means for exercising authority. Bank Markazi is required to determine the followings:

i) Legal reserve requirements for various types of bank deposits of the banks.

ii) Bank-by-bank credit ceilings on aggregate and sectoral credit.

iii) Minimum and maximum expected rate of return from various facilities to the banks.

iv) Minimum and maximum profit shares for banks in their Mudarabah and Musharakah activities.

v) Maximum rate of commissions the banks are to charge for investment accounts for which they serve as trustees.

vi) The minimum ratio of liquid assets to short-term liabilities.

vii) The maximum amount of credit facility granted by banks to each applicant.

viii) The ratio of credit facilities granted by each bank to various deposits.

ix) The maximum amount of commitment made by each bank emanating from opening letters of credit, endorsements issuing guarantees, as well as the type and amount of collateral for such commitments.

Moreover, Bank Markazi is authorized to audit and inspect bank accounts and documents and is further empowered to devise additional regulations to enhance its supervisory authority as the need arises, to ensure and safeguard against threats of bank insolvencies.

Inspite of the above, Bank Markazi has developed procedures based on these guidelines for commercial banks to follow in their transactions (See Table V below)

TABLE V

ISLAMIC REPUBLIC OF IRAN: MODES OF PERMISSIBLE TRANSACTIONS CORRESPONDING TO TYPES OF ECONOMIC ACTIVITY

TYPES OF ACTIVITY	PERMISSIBLE MODE
Production (Industrial, mining, agricultural, etc.) transactions investment,	Musharakah, lease-purchase instalment sales, direct Muzara'ah, Musaqat and Jua'alah.
Commercial	V, Musharakah, Ju'alah.
Service	Lease-Purchase, Instalment sales, Ju'alah.
Housing	Lease-Purchase, instalment, Qard al-hasanah Ju'alah.
Personal consumption	Instalment sales, Qard al-hasanah.

These modes, corresponding to each line of activity as summarized in the Table V above, have made it the responsibility of the banking system to take the lead in implementing and fostering islamic modes of financing throughout the economy. To this end, the role of banks has been broadened far beyond that prevailing under a conventional financial system. This is a clear recognition that, at least throughout the transitional phase, the banking sector will have to play a crucial role as a vehicle through which economic relationships can be transformed into islamic terms.

Considering the comprehensive nature of the law, it is too early to judge the effectiveness of its implementation, but the data available from the first full year of operation of the banking system under the provisions of the laws, permit analysis of some aspects of the implementation phase. Comparative figures for major items in the balance sheet of the banking system for the period March 20, 1984 to March 20, 1985 show that private sector deposits within the banking system increased by 5.7% and that a major portion of old deposits were transferred into new accounts; See Table VI below.

TABLE VI

ISLAMIC REPUBLIC OF IRAN: ASSETS AND LIABILITIES OF THE BANKING SYSTEM, 1984/85

(In billions of Iranian Rials)

ITEM	MARCH, 1984	MARCH, 1985
Private sector deposits	5,600.6	5,918.3
Sight	(1,955.8)	2,509.0
Non-sight	(3,644.8)	(3,409.3)
Old	3,644.8	1,087.9
Savings	(2,737.3)	(716.7)
Time	(907.5)	(371.2)
New	----	2321.4
Qard al-hasanah: Savings	----	(780.0)
Term Investment: Short-term	----	(914.2)
Long-term	----	(627.2)
Credits to the Private Sector	4,256.6	4,500.7
Loan and Credits (old)	4,256.6	3,746.0
Commercial banks	(2,819.2)	(2,288.4)
Specialized banks	(1,437.4)	(1,457.6)
New Facilities	----	754.7
Commercial banks	----	(583.5)
Specialized banks	----	(121.2)

Source: Bank Markazi. "A brief Review of recent Banking Developments in the Islamic Republic of Iran" (Tehran, June 1985).

Although the banking system has been successful in converting its liabilities into Islamic terms, the assets side shows a much slower pace in this conversion. A more detailed breakdown of assets of the banks could be seen in Table VII below.

TABLE VII

ISLAMIC REPUBLIC OF IRAN: BREAKDOWN OF NEW BANKING FACILITIES EXTENDED ACCORDING TO VARIOUS ISLAMIC CONTRACTS

Mode of Transaction	Amount	Share of Each Mode of Total Facility
	(In billions of Rials)	(In %)
Lease-purchase	27.9	3.7
Instalment sale	247.5	32.8
Civil partnership	109.1	14.5
Mudarabah	134.6	17.8
Salaf transaction	26.8	3.5
Legal partnership	37.0	0.3
Direct investment	4.4	4.9
Ju'alah	2.4	0.6
Others	1.6	0.2

Total transaction affecting		
the Profit of investment deposit	591.3	78.3
Debt Purchasing	85.0	11.3
Qard al-hasanah loans	78.4	10.4
Total transactions not affecting		
the profit of investment deposit	163.4	21.7
Total of transactions	754.7	100.0

Source: Bank Markazi "A Brief Review of recent banking developments in the Islamic republic of Iran (Tehran June 19985)

The above table indicates that, the banking system in its first year of operation extended Rls. 754.7 billions in new banking facilities to the private sector of which Rls. 591.3 billions were allocated from investment deposits and the remainder from the bank's resources (Qard al-hasanah deposits).

Additionally, the commercial bank shares in extension of new banking facilities was 77.3% of the total, while that of the specialised banks was 22.7%. This implies that, first, the banking system has been able to employ only about 38% of the available term investment deposits. Second, of the credit facilities extended to the private sector, a major portion has been concentrated in short-term facilities, a fact of which suggests that financial resources have been allocated largely to commercial and trade transactions. Both of these factors can be explained by the various bottle-necks that exist in the system. The most important is the lack of trained personnel. The authorities have indicated that this is partly a problem inherited from the old (conventional) system, in which the rapid growth of the banking system in years immediately preceding the revolution did not permit orderly recruitment and training of bank personnel.

Consequently, Bank Markazi data gathered after the reorganization of the banking system indicated that only 7% of the bank personnel had college degrees, the majority had high school degree and indeed about 75% had less than nine(9) years of banking

experience.

In spite of the above, by March 20, 1985, about 1/3 of the personnel were trained in Islamic modes of banking. Although attempts have been made, through in-house training and Bank Markazi's efforts, to speed up the training of the other 2/3, they are not sufficient. Lack of trained personnel remains an obstacle for banks to overcome in trying to attract, appraise and then finance investment projects in accordance with the provision of the law. The best-trained personnel in terms of project evaluation appraisal and monitoring are concentrated in the specialized banks, but the law has made it attractive for the commercial banks to attempt to attract trained personnel away from the specialized banks, thus exacerbating the personnel bottle-neck problem.

Traditionally, long-term investment financing in various sectors of the economy was concentrated in specialized banks. Hence, these banks were able to attract and train personnel for project financing. Commercial banks generally specialized in short-term financing and credit facilities.

CHAPTER SIX

PROBLEMS BEING FACED IN ISLAMIC BANKING

Problems being faced in the aforementioned countries relates to the legal framework, fiscal policy objectives and instruments (e.g the government deficit financing) and the inadequacy of financial infrastructure that is needed for full implementation of the system.

6.1 LEGAL FRAMEWORK PROBLEM

Among the problems faced by both the Islamic Republic of Iran and Pakistan some stem from the lack of a well-defined legal system; specifying the domain and limitations of property rights and of contracts, that fully corresponds to the established banking system and the Islamic Law. In both countries, this deficiency may have strengthened the environment of uncertainty, limited long-term investment, and forced the banking system to concentrate its asset portfolios in short-term transactions. The problem appears in the two countries differently. For instance, in the Islamic Republic of Iran, where the legal system is basically guided by the Islamic injunctions, the hitch lies in the absence of a legislative definition of the rights and limitation of private property which would explicitly determine the extent and intensity of the private enterprise activities in the economy. While in Pakistan, the

government is forced to establish special banking tribunals to deal with contracts based on Islamic modes since the regular court system as well as existing contract and corporate laws cannot handle Islamic based contracts. In fact, the remedy is a short-term phenomena because in the long-run, it will perpetuate and become more complex, until the legal system and the underlying corporate and contract laws have become more attuned to the legal requirements of the new banking system.

6.2 GOVERNMENT DEFICIT FINANCING PROBLEM

Government's mobility to formulate non-interest based instruments for financing budget deficits serve as a major exponent against a successful implementation of the Islamic system and consequently forced the government to raise funds through borrowing on the basis of a fixed rate of return.

Islam requires an efficient and responsible fiscal policy under which the government can justify and rationalize all its expenditures. Under such a fiscal policy, there is an apparent distinction between a government's general expenditure and its welfare expenditure. The welfare expenditure is to be financed through mandatory fines imposed on income and wealth of the individual members of the society based on the Islamic injunction. If the resources raised in this manner are deemed insufficient, the state is empowered to meet the resources gap through additional

taxes. It could be observed that, writers on the Islamic fiscal system are of the opinion that if the government was to conduct its affairs strictly in accordance with Islamic prescriptions, and if ordinances regarding the duty of sharing were to be strictly observed, and if inefficiency and waste were to be eliminated from government expenditures, then such a government would carry not only a much smaller fiscal burden than at present, but would also have to justify all expenditures.

The problem of structure of taxes and their rationalization is very acute in Pakistan case; because the tax evasion has motivated businessmen to maintain multiple account books and not disclosing their true profits. Consequently, banks have become reluctant and less likely to take risks when undertaking projects on a profit-sharing basis. Therefore, the problems of moral hazard and of monitoring, which tends to be a characteristic of principal-agent type contracts epitomized by Islamic based and profit-sharing arrangements, are made even more complex with these additional constraints. But, in effect, the Taxation Reform Commission, in order to purse this matter has been established by the Pakistan authorities; taken into cognisance because of its beneficial impact on the Islamization process.

Nevertheless, the moral hazard problems which emanate from economic consequences can potentially yield the following:

1. The allocation of credit and of financial resources away from long-term investment projects and toward short-term trade-financing arrangements.

2. The financial intermediation away from the banking system and to the growth of informal financial markets, particularly when the service sector is a major contributor to GDP.

3. It will strengthen and perpetuate the existing bias of the banking system toward large enterprises and against small and indigenous entrepreneurs.

If the financial needs of small businesses are not accommodated by the banking system, they will be forced to seek sources of financing in the private sector which may weaken the effectiveness of the monetary policy.

6.3 THE PROBLEM OF INFRASTRUCTURE

This has a general and a specific dimension. Its general dimension relates to the lack of familiarity of entreprenurs with the requisite of islamic business ethics that, in turn, emanates from their lack of knowledge regarding Islamic ethical rules. Its specific dimension relates to the long-standing problem of inadequate education and training on the part of the staff and

personnel within the banking system.

Even though the latter problem is formidable by itself, the former is by far the more difficult and complex, and requires and enormous amount of time and effort to overcome. In spite of the considerable time to be taken in inculcating islamic business ethics in the minds of market participants, internalization of the rules and norms of economic behaviour that Islam requires, the intervention in, and guidance of the economy by the state ought to be extensive.

CHAPTER SEVEN

SUMMARY, CONCLUSIONS & RECOMMENDATIONS

SUMMARY

This project has focused mainly on the implications of the most salient features of an Islamic financial system in particular - the absence of fixed interest rates. Moreover, the negative repercussions of Riba or interest is apparently exposed in the literature review; where numerous prophetic traditions have been quoted. Equally important is the general Qur'anic injunctions over the Riba issue (See Qur'an; II:275-279. III:130, IV:160-161).

It should be noted that, receiving Riba is a peculiar characteristics of the Jews, who devour others property unlawfully, see Qur'an IV:160. The central requirement of an Islamic financial system is the replacement of the rate of interest with the rate of return on real activities as a mechanism for allocating financial resources. While prohibiting interest, Islam permits profit-sharing based on V and Musharakah concepts. In effect, a variety of modes of transaction have been devised to permit financial system to function without resort to contracts based on fixed interest as the sharing of risk and incentives is a fundamental premise of Islamic banking, models of this banking system provides for the accumulation by banks of loss - compensating balance in

periods of high profit, as well as for deposit insurance, asset diversification and monitoring of projects to reduce the risk borne by investment depositors. For analysing the operation of islamic banking in practice, this project draws upon the experiences of the Islamic Republic of Iran and Pakistan which have recently attempt to introduce Islamic banking on a comprehensive basis. Each has chosen a different path towards the attainment of its objectives. Pakistan has adopted the route of gradual Islamization, that is, step-by-step replacement of its present economic instruments and institutions with their Islamic counterparts commencing with the banking system. On the other hand, the Islamic Republic of Iran has chosen the path of a complete once-and-for-all transformation of the existing system into an Islamic one. Its experience with implementation of full Islamic banking has been shorter than that of Pakistan and has been constrained by enormous exogenous shocks of economy. Even though it is far too soon to discern fully the impact of the adoption of the new system, the two countries experiences of the last few years appears to indicate that they have been able to replace the interest rate mechanism with non-interest-based modes of financial resources allocation without disrupting either the financial stability of the system or the effectiveness of monetary policy.

CONCLUSION:

The prohibition of interest is on issue concurred upon, not only by Islam but almost all the religions of the world as well as the majority of ancient philosophers. According to Islamic faith, interest can never result in any national good or global prosperity. Apparently, it seems that, interest adds to the wealth of a country but in fact, this is nothing but a misnomer.

The only point of difference is that the interest on indigenous credit increases the wealth of a few individuals but impoverishes the centre country while the present banking system adds to the wealth of hundreds of individuals at the detriment of millions of people. In fact, this clearly proves that the custom of interest, irrespective of the form it takes, brings increases misery and distress in its make. Despite its calamities, many local craftsmen, small business entrepreneurs are being induced to transact with; usually through loans granted by People's Bank and Community Bank. However, as a Good Muslim one should bear in mind that, the position of interest/Riba is the sight of Allah(S.W.A) is very great.

> "God will deprive usury of all blessings. But will give increase for deeds of charity ..... "
>
> (II:276)

Moreso, a sound warning is also declared by Allah (S.W.A) where He said:

If you do not, take notice of WAR from God and His Apostle .....

(II:279)

And from a prophetic tradition the Apostle of Allah (S.A.W) is reported to have said:

"Allah (S.W.A) has cursed the one who takes interest, the one who pays it, the one who writes the contract, and the one who witnesses the contract.

(Reported by : Abu Ahmad, Abu Dawud, Al-Nisa'i and Al-Tirmidhi - who called it, a sound Hadith) or (See: Yusif Al-Qaradawi: Halal Wal-Haram, Page 267).

RECOMMENDATIONS

There are three important sources of these problems, viz:

a) The lack of a legal framework that unambiguously specifies the domain and limitations of property rights and of contracts in accordance with an Islamic banking system.

b) The difficulty of devising non-interest-based sources for financing government deficits, and

c) The lack of adequate financial infrastructure, including trained banking staff, and the means for dealing with higher information and transaction costs to both depositors and banks.

Hence, the existence of the above constraints can create acute uncertainties reducing the scope of long-term investment financing and leading to further strengthening of the observed concentration of the portfolio of the banking system in short-term assets.

At stake is stimulation and maintenance of a flow of financial intermediation high enough to support a rate of long-term fixed capital formation that fully exploits available social rates of return to long-term investment. Moreover, business attitudes would have to change to allow for a transaction toward investment-oriented financing, which is the ultimate objective of the Islamic system.

It could also be suggested that, the distortions underlying the existence of large fiscal deficits would have to be corrected. Fixed rate charges (e.g. interest paid by the government debts), while narrowing no relationship to the prohibition of expenditure financed by borrowed funds, would act as a floor for bank charges on other financing operations. Therefore, appropriate expenditure and national tax policies would be needed to establish a closer relationship between rates of return and charges and thus promote

a movement toward the acceptance of profit and loss sharing, which is essential for the growth of long-term financing by commercial banks.

Recently, Mushin Khan (a reputable Islamic scholar) suggested a different model of Islamic banking. This model, also based on profit and loss sharing; divides the liability side of the balance hset of the Bank into two windows. One contains demand deposits (transaction deposits), and the other contains investment balances. The choice of window is left to the depositor. Khan's model requires a 100% reserve for demand deposits, on the presumption that such deposits are placed as amana (safe-keeping) and therefore must be fully backed by reserves because the bank does not have the right to use these deposits which belong to depositors as the basis for money creation through financial reserves. Money deposited in investment accounts, on the other hand, is placed with the depositor's full knowledge that it will be invested in risk-bearing, projects, therefore no guarantee is justified and the model stipulated no reserve requirements for the second window.

> "Our Lord! We believe in what Thou hast revealed, and use follow the Apostle; then write us down among those who bear witness".
>
> (III:53)

"Is the man who follows the good pleasures of God like

the an who draws on himself the wrath of God and whose abode is in Hell; A woeful refuge! They are in varying grades in the sight of God, and God sees well all what they do"

(III:162 & 163)

It should be noted that:

"God did confer a great favour on the Believers when He sent among them an Apostle from among themselves rehearsing unto them the signs of God sanctifying them and instructing them in scripture and wisdom, while, before that, they had been in manifest error". III:164

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