

# PROHIBITION OF INTEREST

*Does it make sense?*

*By Dr. M. Umer Chapra*

Dr. Umer Chapra's "Prohibition of Interest: Does it make sense?" is a collection of several papers on the whole question of interest-free banking.

Though interest-free banking made its debut in the modern world as early as 1975 when the first interest-free bank was established in Dubai, and has since grown tremendously with over 200 such banks existing all over the world, with many in the Western hemisphere, and there is an ever-increasing number of "Islamic Windows" in conventional banks, there are still, however, sceptics, Muslim and non-Muslim, are still questioning whether Islam really prohibited interest, whether there is any benefit and sense in the prohibition of interest and whether it is feasibly practicable and achievable to establish true and genuine interest-free banks.

In a simple format and style aimed primarily for the lay person, Dr. Chapra in this booklet addresses these issues convincingly and with appropriate facts and figures to establish his points. Amazingly, he also quotes several specialists from the Western banking systems who came to similar conclusions and/or who are now beginning to see wisdom in the whole question of interest-free banking. This book is a wonderful and appropriate first step exposure to interest-free banking for those who need just that little convincing as well as for those who will later wish to delve further and deeper into the subject.

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In the Name of Allah Most Gracious Most Merciful

# **PROHIBITION OF INTEREST:**

## **Does it make sense?**

(Revised Edition)

**By**  
**Dr. M. Umer Chapra**



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## FOREWORD

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By the grace of Allah, the first edition of the booklet was well-received and served the primary purpose of promoting satisfaction that the historical consensus on the prohibition of interest in the Qur'an and the Sunnah is well-founded. It also helped create a conviction that there is a strong rationale behind the prohibition and that it is because of this rationale that all other major religions (Hinduism, Judaism and Christianity) have also prohibited interest. It also indicated briefly how financial intermediation can take place successfully without interest.

The demand for the booklet has continued to be strong and we are happy to bring out its second edition after its revision and expansion by Dr. Chapra. The international financial crisis, in the tight grip of which the world was recently, has created a conviction that introduction of risk-sharing is essential for minimizing excessive lending which is one of the most important causes of financial crises. This has, accordingly, raised the attractiveness of Islamic finance. The second edition, therefore, includes an additional chapter analyzing the major causes of financial crises and how Islamic finance can help minimize the frequency and severity of such crises in the future. This will add further value to the booklet.

I take this opportunity to extend my grateful thanks to Dr. Chapra for revising and updating the contents of the first edition and

also for making available a new chapter which is a somewhat revised version of a paper published in the January 2009 issue of the *New Horizon*, a magazine of the Institute of Islamic Banking and Insurance, London. I am also grateful to brothers Mohammed Farooq Moinuddin and Ibrahim Wazir for providing the necessary secretarial assistance to Dr. Chapra for preparing the second edition.

And last but not the least, it would be highly ungrateful of me if I do not thank Prof. Dr. Azmi Omar, Director General of the Islamic Research & Training Institute, for the help and cooperation he has generously given in all the different stages of its preparation.

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Dr. Chapra had made seminal contributions to Islamic Economics and Finance over more than four decades in the form of eleven books and more than seventy papers and book reviews. Consequently, he has received a number of awards, including the Islamic Development Bank Award for Islamic Economics, and the King Faysal International Award for Islamic economics and finance, both in 1989. He also received the COMCEC 30<sup>th</sup> Anniversary Academic Award in November 2014 from President Recep Tayyip Erdogan of Turkey for his “outstanding academic studies on Islamic economics and finance”.

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**CHAPTER ONE**

**HAS ISLAM REALLY  
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**Interest or Ribā: Which is prohibited?**

Is interest really prohibited in Islam? This question is often repeated at different social gatherings because some people tend to argue that it is *ribā* which has been prohibited by Islam and that bank interest is not equivalent to *ribā*.

There is no doubt that what has been prohibited by both the Qur’ān and the *hadīth* is *ribā*. The Qur’ān has prohibited it in four different revelations, the first of which (30:39) was in Makkah, and the other three (4:161, 3:130-2 and 2:275-81) were in Madinah. The last of these (2:275-81) came near the end of the Prophet’s life, peace and blessings of God be on him. It severely censured those who took *ribā*, and declared them to be at war with God and His Prophet. It also established a clear distinction between trade and *ribā*, and enjoined Muslims to forego all outstanding *ribā*, enjoining them to take only the principal amount, and to remiss even this in case of the borrowers’ hardship.

The Prophet, peace and blessings of God be on him, also prohibited *ribā* in the most unambiguous words, and condemned not only those who take it, but also those who give it, those who

record the transaction, and those who act as witnesses to it.<sup>1</sup> He even equated the wilful taking of *ribā* with committing adultery thirty-six times or being guilty of incest with one's own mother.<sup>2</sup>

Since *ribā* has been censured severely by both the Qur'ān and the *Sunnah* it is difficult to believe that it would be left so undefined that even after fourteen centuries some people would fail to understand its meaning clearly. Hence, it is necessary to go back to the classical sources of Islam to determine what the term *ribā* really stands for.

*Ribā* literally means increase, addition, expansion or growth.<sup>3</sup> It is, however not every increase or growth which has been prohibited by Islam. Profit also leads to an increase in the principal amount but has not been prohibited. So what is it that has been prohibited?

The best person to answer this question would, of course, be the Prophet himself, peace and blessings of God be on him. He prohibited the taking of even a small gift, service or favour as a condition for the loan.<sup>4</sup> This answer of the Prophet equates *ribā*

1 Narrated by Muslim from Jābir and also by al-Tirmidhī and Ahmad. For the full texts and complete references to the ahādith quoted in this paper, see Chapra 1985, pp. 236-40.

2 The first hadīth is narrated by Ahmad and al-Dāraqutnī from Abdallah ibn Hanzalah, while the second is narrated by Ibn Mājah and al-Bayhaqī (Shu'ab al-Imān) from Ibn 'Abbās.

3 See the word *ribā* in Ibn Manzūr's *Lisān al-'Arab*; 1968; al-Zabīdī's *Tāj al-'Arūs*; and Rāghib al-Isfahānī's *al-Mufradāt*. The same meaning is also unanimously indicated in all classical Qur'ān commentaries.

4 The Prophet, peace and blessings of God be on him, said: "If a man extends a loan to someone he should not accept a gift" (Bukhārī in his *Tārīkh* and Ibn Taymiyyah in *al-Muntaqā*). In another hadīth the Prophet said: "When one person grants a loan to another and the borrower offers him a dish [of food] or a ride on his animal, he should not accept it unless the two of them have been previously accustomed to the mutual exchange of such favours" (Sunan al-Bayhaqī, *Kitāb*

with what is commonly understood to be interest. This meaning of *ribā* has become reflected in the writings of all scholars in Muslim history. There is hardly any classical Qur'ān commentary or Arabic dictionary which gives a different meaning. For example, al-Qurtubī (d.671 AH/1070 AC), considered to be one of the most illustrious Qur'ān commentators, clearly indicates that "Muslims are agreed on the authority of their Prophet that the condition for an increase over the amount lent is *ribā*, irrespective of whether it is a handful of fodder, as indicated by Ibn Mas'ūd, or a particle of grain."<sup>5</sup> Ibn Manzūr (d.711 AH/1311 AC) also clearly states in his authoritative dictionary of the Arabic language (*Lisān al-'Arab*) that "what is prohibited is the extra amount, benefit or advantage received on any loan".<sup>6</sup> The term *ribā* has, thus, been understood from the earliest times to stand for the 'premium' that the borrower is required to pay to the lender along with the principal amount as a condition for the loan or for an extension in its maturity.<sup>7</sup> This is also the unanimous verdict of a number of international conferences of *fuqahā'* held in modern times to discuss the question of *ribā*, including the Mu'tamar al-Fiqh al-Islāmī held in Paris in 1951 and in Cairo in 1965, and the OIC and Rabitah *Fiqh* Committee meetings held in 1985 and 1986 in Cairo and Makkah respectively.<sup>8</sup> In the presence of such an overwhelming consensus, there is no room

al-Buyū', Bāb Kullu qardin jarra manfa'atan fa huwa riban). Is it possible to conceive of a lower rate of interest than a plate of food or a ride in one's car?

5 Tafsīr al-Qurtubī, 1967, Vol. 3, p.241.

6 Ibn Manzūr, 1968, p. 304. See also the commentary on verse 2:275 in Tafsīr al-Kabīr of Fakhrudīn al-Rāzī, *Ahkām al-Qur'ān* of Abū Bakr al-Jassās, and *Ahkām al-Qur'ān* of Ibn al-'Arabī.

7 See, al-Jazīrī, Vol. 2, p.245.

8 See al-Sanhūrī, 1953/54, Vol.3, pp.241-2 and al-Qaradāwī, 1994, pp.129-42. See also Abdel Hamid al-Ghazali, 1990, pp.35-60, for verdicts about *ribā* given from 1900-89.

for arguing that interest is not prohibited in Islam. A few isolated opinions by some modern scholars expressing a different view do not, therefore, create a dent in the consensus.

This gives rise to the question of what is it that confuses some people about its meaning. The reason may perhaps lie in the term *ribā* being used in the *Sharī‘ah* in two different senses, and the difficulty of some people in clearly understanding the meanings and implications of both. The first is *ribā al-nasī‘ah* and the other is *ribā al-faḍl*.

### ***Ribā al-Nasī‘ah***

The term *nasī‘ah* comes from the root *nas’a* which means to postpone, defer, or wait, and refers to the time that is allowed to the borrower to repay the loan in return for the ‘addition’ or the ‘premium’. Hence *ribā al-nasī‘ah* is equivalent to the interest charged on loans. It is in this sense that the term *ribā* has been used in the Qur’ān in verse 2:275, which states that “God has allowed trade and forbidden *ribā* (interest).” This *ribā* is also termed as *ribā al – Qur’ān* (*ribā* specified in the Qur’ān) or *ribā al-duyūn* (*ribā* on loans).

The prohibition of *ribā al-nasī‘ah* essentially implies that the fixing in advance of a positive rate of return on a loan as a reward for waiting is not permitted by the *Sharī‘ah*. It makes no difference whether the rate of return is small or big, or a fixed or variable per cent of the principal, or an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan. The point in question is the predetermined positiveness of the return. It is important to

note that, according to the *Sharī‘ah*, the waiting involved in the repayment of a loan does not by itself justify a positive reward.

There is no room even for arguing that the prohibition applies only to consumption loans and not to business loans. This is because the borrowing during the Prophets’ times was not for consumption purposes but rather for financing long distance trade. Accordingly, the late Shaykh Abū Zahrah, one of the most prominent Islamic scholars of the twentieth century, has rightly pointed out that:

There is absolutely no evidence to support that the *ribā* of *al-Jāhiliyyah* [pre-Islamic days] was on consumption and not on development loans. In fact the loans for which a research scholar finds support in history are production loans. The circumstances of the Arabs, the position of Makkah and the trade of Quraysh, all lend support to the assertion that the loans were for production and not consumption purposes.<sup>9</sup>

Even Professor Abraham Udovitch, Ex-Chairman of the Department of Near Eastern Studies at the Princeton University, has clarified that “Any assertion that medieval credit was for consumption only and not for production, is just untenable with reference to the medieval Near East.”<sup>10</sup>

There is, thus, absolutely no difference of opinion among all schools of Muslim jurisprudence that *ribā al-nasī‘ah* stands for interest and, is *harām* or prohibited. The nature of the prohibition is strict, absolute and unambiguous.<sup>11</sup> However, if the return on the principal can be either positive or negative, depending on the

9 Abū Zahrah, 1970, pp.53-4.

10 Udovitch, 1970, p.86.

11 Al-Jazīrī, Vol.2, p.245.

final outcome of the business, which is not known in advance, it is allowed provided that it is shared in accordance with the principles of justice laid down in the *Sharī'ah*.

### ***Ribā al-Faḍl***

While Islam has prohibited interest on loans and allowed trade, it has not allowed everything in trade. This is because it wishes to eliminate not merely the injustice that is intrinsic in the institution of interest on loans, but also that which is inherent in all forms of dishonest and unjust exchanges in business transactions. Anything that is unjustifiably received as 'extra' by one of the two counterparties to a trade transaction is *ribā al-faḍl*, which may be defined in the words of Ibn al-'Arabī as "all excess over what is justified by the counter-value."<sup>12</sup>

The prohibition of *ribā al-faḍl* is intended to ensure justice, to remove all forms of exploitation through 'unfair' exchanges, and to close all back-doors to *ribā* because, according to the unanimously accepted legal maxims of Islamic jurisprudence, anything that serves as a means to the unlawful is also unlawful. Since people may be exploited or cheated in several different ways, the Prophet warned that a Muslim could indulge in *ribā* in seventy (= several) different ways.<sup>13</sup> This is the reason why the Prophet, peace and blessings of God be on him, said: "Leave what creates doubt in your mind in favour of what does not create doubt",<sup>14</sup> and Caliph 'Umar was inspired to say: "Abstain not only from *ribā* but also from *rībah*."<sup>15</sup> *Rībah* is from *rayb*

12 Ibn al-'Arabī, *Ahkām al-Qur'ān*, 1957, p.242.

13 Reported by Ibn Mājah and al-Bayhaqī – (Shu'ab al-Īmān) from Abū Hurayrah.

14 Cited by Ibn Kathīr in his commentary on verse 2:275.

15 Reported by Ibn Mājah and al-Dārimī from 'Umar ibn al-Khaṭṭāb.

which literally means 'doubt' or 'suspicion' and refers to income which has the semblance of *ribā* or which raises doubts in the mind about its rightfulness. It covers all income derived from injustice to, or exploitation of, others.

The Prophet, peace and blessings of God be on him, has indicated, by way of example, at least four different ways of indulging in *ribā al-faḍl*. The first of these is the exploitation that can take place in trade through the use of unfair means even though trade is by itself allowed. He equated with *ribā* even the cheating of an unsophisticated entrant into the market (*ghabn al-mustarsil*) and the rigging of prices in an auction with the help of an agent (*al-najash*).<sup>16</sup> Analogically one may conclude that the extra money earned through such exploitation and deception falls within the ambit of *ribā al-faḍl*.

Another way of being guilty of indulging in *ribā al-faḍl* is by accepting a reward in return for making a recommendation in favour of a person. This implies that the performance of an apparently charitable act with the intention of making money surreptitiously is also prohibited. The rationale behind this may be that such a money-motivated recommendation might give benefit to a person who does not deserve and, thereby, indirectly deprive others who are more deserving.<sup>17</sup>

A third way of indulging in *ribā al-faḍl* is through barter transactions because of the difficulty of measuring the counter-

16 The first hadīth is reported by al-Bayhaqī and al-Suyūṭī (al-Jāmi' al-Ṣaghīr) from Anas ibn Mālik. The second hadīth is reported from Abdallah ibn Abī Awfā by al-'Asqalanī in his commentary on al-Bukhārī and by also al-Bayhaqī in his Sunan from Anas ibn Mālik..

17 Reported from Abū Umāmah by Bulūgh al-Marām on the authority of Ahmad and Abū Dāwūd.

values precisely in such transactions. The Prophet, peace and blessings of God be on him, therefore, discouraged barter in a monetized economy and required that the commodity to be exchanged on the basis of barter be sold against cash and the proceedings used to buy the needed commodity.

This leads to the fourth way of indulging in *ribā al-faḍl* which has received the maximum attention of the *fuqahā'*. A number of authentic *ahādīth* stipulate that if the same genus of commodities is exchanged against each other then the same quantity and weight of the commodities should be exchanged (*sawa'an bi sawa'in* and *mithlan bi mithlin* or equal for equal and like for like) hand-to-hand (*yadan bi yadin*). If the commodities exchanged are different, it does not matter if there is difference in weight and quantity, provided that the exchange takes place hand to hand. One of the implications of this requirement is the elimination of the backdoor to *ribā* (which is referred to in *fiqh* as *sadd al-dharī'ah*). Another implication of these *ahādīth*, as understood by the *fuqahā'*, is the prohibition of futures transactions in foreign exchange. This is because, if the rate of exchange is fixed in advance for a futures exchange in currencies, there may be a great deal of injustice if the market rate of exchange changes. The *Sharī'ah*, therefore, requires that in a futures transaction the exchange must take place on the basis of the rate prevailing on the date of settlement. However, whether hedging, which is one way of managing the risks involved in exchange rate fluctuations, is possible within the constraints of the *Sharī'ah*, continues to be an unresolved *fiqhi* issue.<sup>18</sup>

18 This issue has been discussed by a number of scholars, including Kamali, 1996; Chupra and Khan 2000; Khan and Habib 2001; and al-Suwailem, 2006.

*Ribā al-nasī'ah* and *ribā al-faḍl* are, thus, essentially counterparts of the verse "God has allowed trade and prohibited *ribā*" (2:275). While *ribā al-nasī'ah* relates to loans and is prohibited in the second part of the verse, *ribā al-faḍl* relates to trade and is implied in the first part. Because trade is allowed in principle, it does not mean that everything is allowed in trade. Since the injustice inflicted through *ribā* may also be perpetuated through transactions in commodities and currencies, *ribā al-faḍl* refers to all such injustices or exploitations. It requires the absence of rigging, monopoly, uncertainty and speculation. It demands a fair knowledge of the prevailing prices and the quality of goods being purchased or sold on the part of both the buyer and the seller. It necessitates the elimination of cheating in prices or quality, and in measures or weights. All business practices which lead to the exploitation of the buyer or the seller must be effectively eliminated.<sup>19</sup>

While *ribā al-nasī'ah* can be defined in a few words, *ribā al-faḍl*, interspersing a vast array of business transactions and practices, is not so easy to specify. This is what may have prompted 'Umar, the Second Caliph, to say: "The Prophet, peace and blessings of God be on him, was taken without elaborating it to us."<sup>20</sup> The attempt to justify *ribā al-nasī'ah* or the interest on loans on the basis of this saying of 'Umar is absolutely fallacious because the

19 Several types of sales have been prohibited in the *Sharī'ah* with the objective of safeguarding the right of both buyers and sellers. Examples are: najash (rigging and collusion), ghabn al-mustarsīl (cheating of an unsophisticated entrant into the market), bay'al-hādir li al-bādī and talaqqī al-rukban (both implying monopsonistic or monopolistic collusion or exploitation to lower or raise prices beyond what is justified by market conditions), gharar, muhāqalah, munābadhah, mulāmasah and muzābanah (sales involving uncertainty and speculation or gambling). See, for example, al-Jazīrī, Vol.2, pp.273-8 and 283-91).

20 Reported by Ibn Mājah and al-Dārimī from 'Umar ibn al-Khattāb.

reaction of ‘Umar, by way of caution, was to give up not only *ribā* but also *rībah*.

It is true that the Prophet specified only a few ways of indulging in *ribā al-faḍl* and did not indicate all the different ways, as one may have desired. However, this was not necessary and not even feasible. Forms of injustice and exploitation in trade and exchange of currencies have changed over the centuries and it was not possible for anyone to foresee and specify them all 1400 years ago. The Qur’ān and the *Sunnah* are there to provide the principles on the basis of which the *Ummah* can do so. This is the ongoing challenge to all Muslims – to examine their economic practices continually in the light of Islamic teachings and to eliminate all shades of injustice. This is a more difficult task than eliminating *ribā al-nasī’ah*. It requires a total commitment and an overall restructuring of the entire economy within the Islamic framework to ensure justice. This was, and is, the unique contribution of Islam. While *ribā al-nasī’ah* was well-known in the *Jāhiliyyah*, the concept of *ribā al-faḍl* was introduced by Islam and reflects the stamp of its own unflinching emphasis on socio-economic justice.

### **CONCLUDING REMARKS**

The principal reason why the Qur’ān has delivered such a harsh verdict against interest is that Islam wishes to establish an economic system where justice is ensured and exploitation in all its various forms is eliminated. This necessarily implies that the injustice perpetuated through the assurance of a positive rate of return given to the financier without doing any work or sharing in the risk is unjust when the entrepreneur is not assured of such a positive return in spite of his management and hard

work. Islam has, therefore, prohibited interest and enjoined profit-and-loss sharing to ensure justice between the financier and the entrepreneur.

Under these circumstances, it is difficult to see how anyone could justify interest in an Islamic society. The difficulty to understand the prohibition comes from lack of appreciation of the whole complex of Islamic values, and particularly its uncompromising emphasis on socio-economic justice and equitable distribution of income and wealth. Any attempt to treat the prohibition of *ribā* as an isolated religious injunction and not as an integral part of the Islamic economic order with its overall ethos, goals and values is bound to create confusion.



## CHAPTER TWO

### PROHIBITION OF INTEREST: DOES IT MAKE SENSE?

The previous chapter argued that the Qur'ān has prohibited interest strictly and has declared those who take it to be at war with God and His Prophet (2:279). The Prophet, peace and blessings of God be on him, also condemned interest and equated the indulgence in it with committing adultery thirty-six times or incest with one's own mother. No distinction has been made between usury and interest, and even a small gift is not allowed as a condition for a loan.

However, it is not only Islam which has prohibited interest. Other major religions like Judaism, Christianity and Hinduism, have also done the same. The followers of these four religions constitute around two-thirds of the world's population. The Bible disapproved of interest severely and did not recognize any distinction between usury and interest.<sup>21</sup> Those who took interest were considered to be wicked and stigmatized.<sup>22</sup> They could not be admitted to communion or receive Christian burial in accordance with a verdict of the Third Lateran Council (1179).<sup>23</sup>

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21 For the Babylonian, Jewish and Christian views on interest, see, Johns, et.al. in Hastings, Vol.12, pp. 548-58; and Noonan, 1957, p.20. For the Hindu view, see Bokare, 1993, p.168.

22 See the Bible – Ezekiel, 18:8, 13, 7; 22:12. See also Exodus, 22: 25-27; Leviticus, 25:36-38; Deuteronomy, 23:19; and Luke, 6:35.

23 Johns et.al, p.551.

The *Talmud* compared the money-lender to a murderer and the *Mishnah* disqualified him from giving evidence in a court of law.<sup>24</sup> In addition, a number of highly respected philosophers like Plato and Aristotle have also condemned interest. This raises the question of why there is such a harsh verdict against interest. Is there any sound rationale behind it?

### **Borrowing: Was it primarily by the Poor or the Rich?**

Those who are against the prohibition assume that interest was prohibited mainly because of the injustice it inflicted on the poor, who were charged exorbitant rates of interest for loans borrowed by them to satisfy some urgent need. This, they argue, led to exploitation and further impoverishment of the poor. They, therefore, conclude that the prohibition of interest is no longer valid because banks in modern times do not resort to such exploitation.

The assumption on which this conclusion is based does not, however, reflect the historical realities. It was not the poor who undertook borrowing during the Prophet's days, peace and blessings of God be on him. This is because the needs of the poor were taken care of either by the rich or the *bayt al-mal* (the Public Treasury) near the end of the Prophet's life when the prohibition of interest became strictly enforced. Therefore, the poor did not have to borrow to fulfil their needs.

This, then, leads us to the question of who borrowed and why? It was primarily the tribes and rich traders who borrowed. They operated as large informal partnerships to conduct large-scale trade. This was necessitated by the prevailing circumstances.

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<sup>24</sup> Ibid, p.558.

The difficult terrain, the harsh climate, and the slow means of communication made the task of trade caravans difficult and time-consuming. It was not possible for them to undertake several business trips to the East and the West during a given year. Only a few trips could be undertaken. Hence, it was necessary for the caravans to muster a large volume of financial resources to purchase all the exportable products of their society, sell them abroad, and use the proceeds to bring back the entire import needs of their society.

Before Islam, such resources were mobilized on the basis of interest. This was not acceptable to Islam because it led to injustice. If there was a loss, it was the entrepreneur or the trader who had to bear the entire loss in spite of all the trouble he took. The financier, who did nothing more than providing finance, got a predetermined positive rate of return. Islam, therefore, tried to remove the injustice resulting from this. It abolished the interest-based nature of the financier-entrepreneur relationship and reorganized it on the basis of profit-and-loss-sharing. This enabled the financier to have a just share and the entrepreneur did not get crushed under adverse conditions, one of which could be the caravan being waylaid on the way.

This shows that, although the extension of meaningful help to the poor carries a high priority in the Islamic value system, it was not the primary reason for the prohibition of interest. The primary reason was the realization of overall socio-economic justice, which is declared by the Qur'ān to be the main mission of all God's messengers (57:25).

### **Interest and the Realization of Humanitarian Goals**

Justice, however, has a much wider implication. Confining it merely to trade may not be able to take us far enough. Justice demands that the resources provided by God to human beings as a trust must be utilized in such a manner that the universally-cherished humanitarian goals of general need fulfilment, full employment, equitable distribution of income and wealth, and economic stability are optimally realized. It is the contention of this paper that these humanitarian goals would be realized more effectively if there is also a humanitarian strategy. An important, though not the only, element of such a strategy is the abolition of interest. The following discussion tries to show briefly how the interest-based financial system frustrates the optimal realization of these goals and how its reorganization in a way that increases the reliance on equity and reduces that on debt can help in their more effective realization.<sup>25</sup>

#### ***Need Fulfilment***

Interest-based financial intermediation tends to allocate financial resources among borrowers primarily on the criterion of their having acceptable collateral to guarantee the repayment of principal and sufficient cash flow to service the debt. End-use of financial resources does not constitute the main criterion. Even though collateral and cash flow are both indispensable for ensuring repayment of loans, giving them undue weight leads to a relative disregard of the purpose for which borrowing takes place. Hence, financial resources go mainly to the rich, who have the collateral as well as the cash flow, and to governments, who, it

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25 This subject has been discussed in greater detail by the author in Chapra, 1985, pp.19-29 and 107-145; 1992, pp. 327-34; and 2007.

is assumed, will not become bankrupt. However, the rich borrow not only for productive investment but also for conspicuous consumption and speculation, while the governments borrow not only for development and public well-being, but also for chauvinistic defense build-up and white elephant projects. This leads to excessive lending and does not only accentuate macroeconomic and external imbalances, but also squeezes the resources available for need fulfilment, productive investment and development. This explains why even the richest countries in the world like the United States have been unable to ensure need fulfilment of all and full employment in spite of their desire to do so and the relatively abundant resources at their disposal.

#### ***Full Employment***

The excessive lending and living beyond means that the interest-based financial intermediation has the tendency to promote through the easy availability of credit, has led to a rise in consumption by both the public and private sectors. Gross domestic saving as a percent of GDP has accordingly registered a substantial decline in the world over the last three decades from 23.2 percent in 1990 to 19.8 percent in 2010. That in developing countries, which need higher savings to accelerate development without a significant rise in inflation and debt-servicing burden, has been even steeper over the same period.<sup>26</sup> This has led to lower rates of rise in investment from domestic resources, which has joined hands with structural rigidities and some other socio-economic parameters to reduce the rates of growth in output and employment in a number of countries around the world.

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26 Figures have been derived from the Table on “Gross Domestic Savings Percent of Gdp – wb Data (<http://www.tradingeconomics.com/country-list/gross-domestic-savings-percent-of-gdp-wb>) as of 2/8/2015, p. 15

Unemployment has hence become one of the most intractable problems of most countries, including those in the rich industrial world. Unemployment stands at around 11.4 percent at present in the Euro Area, much higher than 7.8 percent in 2008 and close to four times its level of 2.9 percent in 1971-73.<sup>27</sup> It is not expected to fall significantly below this level in the near future because the real rate of growth in these countries has tended to be consistently lower than what is necessary to reduce unemployment significantly. Even more worrying is the higher than average rate of youth unemployment because it hurts their pride, dampens their faith in the future, increases their hostility towards society, and damages their personal capacities and potential contribution.<sup>28</sup>

A decline in speculation and wasteful spending along with a rise in saving and productive investment could be very helpful. But this may not be possible when the value system encourages both the public and the private sectors to live beyond their means and the interest-based financial intermediation makes this possible by making credit easily available without due regard to its end use. If, however, banks were to share in the risks and rewards of financing and credit was made available primarily for expanding employment opportunities and real output, the banks

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27 OECD, *Economic Outlook*, December 1991, Table 2, p.7; and December 2008, Table 13, p. 261, and <http://www.tradingeconomics.com/country-list/unemployment-rate>.

28 A question may be raised here about the normally low rate of unemployment in the U.S. in spite of a substantial decline in household saving. There are a number of reasons for this. One of the most important of these is the large inflow of foreign funds which “has helped to fund a pronounced increase in the rate of growth of the nation’s capital stock”(Peach and Steindel, September 2000, p.1). Once there is a reversal of, or even a decline in, this inflow, it may be difficult to sustain the high rate of growth in output and employment. In addition the stock market may also experience a steep decline.

may tend to be more careful in lending and credit expansion may be in step with the real needs of the economy. Unproductive and speculative spending may decline and more resources may become available for productive investment and development. This should help promote higher growth, a rise in employment opportunities, and a gradual decline in unemployment.

### ***Equitable Distribution***

The inequitable allocation of financial resources in the conventional interest-based financial system is now widely recognized. According to Arne Bigsten, “the distribution of capital is even more unequal than that of land” and “the banking system tends to reinforce the unequal distribution of capital.”<sup>29</sup> The reason is that, as already indicated, financial intermediation helps mobilize resources from a vast cross-section of society, but their benefit goes generally to the rich, a much smaller spectrum. As Mishan has rightly pointed out: “Given that differences in wealth are substantial, it would be irrational for the lender to be willing to lend much to the impecunious as to the richer members of society, or to lend the same amounts on the same terms to each”.<sup>30</sup> The Morgan Guarantee Trust Company, one of the largest banks in the U.S., has admitted that the banking system has failed to “finance either maturing smaller companies or venture capitalists,” and “though awash with funds, is not encouraged to deliver competitively priced funding to any but the largest, most cash-rich companies.”<sup>31</sup>

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29 Bigsten, 1987, p.156.

30 Mishan, 1971, p.205.

31 Morgan Guarantee Trust Company of New York, 1987, p.7.

In contrast with this, risk-reward sharing could be more conducive to the realization of equity. It would tend to compel the financier to give due consideration to the strength of the project, thus making it possible for competent entrepreneurs from even the poor and the middle-classes to be at least considered for financing if they have worthwhile projects, adequate managerial ability, and a reputation for honesty and integrity. This may enable society to harness the pool of entrepreneurial ability from even the poor and middle classes. The rich contribution that such entrepreneurs can make to output, employment and need fulfilment could thus be tapped.

There is no reason to be unduly apprehensive about loan losses from such financing. The experience of the International Fund for Agricultural Development (IFAD) is that credit provided to the most enterprising of the poor is quickly repaid by them from their higher earnings.<sup>32</sup> Other small-loan programmes in Bangladesh, Pakistan and some other countries have yielded similar results. Nevertheless, it may be desirable to arrange insurance of small loans to provide protection to financiers, particularly against fraud and mismanagement.

### ***Economic Stability***

Economic activity has fluctuated throughout history for a number of reasons, some of which, like the natural phenomena, are difficult to remove. However, economic instability seems to have become exacerbated over the last three decades as a result of turbulence in the financial markets. One of the important reasons for this, according to Milton Friedman, a Nobel laureate,

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<sup>32</sup> The Economist, 16 February 1985, p.15.

is the erratic behaviour of interest rates.<sup>33</sup> The high degree of interest rate volatility injects great uncertainty into the financial market and makes it difficult for entrepreneurs to take long-term investment decisions with confidence. This drives borrowers and lenders alike into the shorter end of the financial market. The result is an excessive rise in highly leveraged short-term debt, which plays an important role in leading first to unsustainable rise in assets prices and then to their fall, thereby, destabilizing financial markets and giving rise to financial crises.

One may wish to pause here to ask why an excessive rise in short-term debt should accentuate instability and cause financial crises. This is because short-term debt is easily reversible as far as the lenders are concerned. Its repayment is, however, difficult for the borrowers if the amount is locked up in medium – and long-term investments with a long gestation period. While there is nothing basically wrong in a reasonable amount of short-term debt, which Islam allows on the basis of its sales-based modes of financing for real goods and services, an excess of it tends to get diverted to speculation in the foreign exchange, commodity and stock markets, giving rise to a steep rise in asset prices. Unwinding later on leads to a steep fall in their prices, debt crises and financial fragility.

The 1997 East Asia crisis has clearly demonstrated this. The Eastern tigers had healthy fiscal policies which could be the envy of a number of developing countries. However, the large inflow of short-term foreign funds led to rapid growth in bank credit to the private sector. This created speculative heat in the stock and property markets. It was the old mistake of lending on collateral

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<sup>33</sup> Friedman, 1982, p.4.

without evaluating the underlying risks. As soon as there was a shock, there was a rapid outflow of funds, which had come primarily, on a short-term basis. This led to a precipitous fall in asset prices and exchange rates, making the borrowers unable to repay to the local banks, which could not in turn repay their short-term loans from foreign banks. There was thus a banking crisis. The IMF had to come to the help of these countries by arranging a huge amount of loans. What this ended up doing was to enable the foreign banks to get back their money and go scot-free. The burden of the debt consequently shifted to the governments and, ultimately, to the taxpayers of these countries.

The 1998 collapse of the hedge fund, LTCM (Long-term Capital Management), was also due to highly-leveraged short-term lending. On the strength of their own equity, the hedge funds are able to borrow enormous amounts that they use to speculate in the international commodity, stock and foreign exchange markets, and thus end up destabilizing financial markets around the world. The leverage of LTCM was 25:1 before the crisis, but rose to 50:1, and ultimately to 167:1, after the crisis.<sup>34</sup> If the Federal Reserve had not come to its rescue, the whole world economy might have been driven to the precipice of a serious financial crisis.

The heavy reliance on short-term borrowing has injected a substantial degree of instability in even the financial, stock and commodity markets, including the international foreign exchange markets. Daily turnover in the international foreign

<sup>34</sup> IMF, World Economic Outlook, December 1998, p.55. Leverage indicates the extent of borrowing on the basis of equity. A leverage of 25:1 means a loan of \$25 on the strength of a capital of \$1. When the leverage is high, it is difficult for borrowers to repay their loans when asset prices fall.

exchange markets was \$5.3 trillion per day in April 2013<sup>35</sup>, which was 452.6 times the average daily volume of \$11.71 billion in world merchandise trade.<sup>36</sup> Even if one allows for services and genuine capital transfers, one could easily conclude that a substantial volume of foreign exchange transactions is for speculative purposes. According to Andrew Crockett, General Manager of the Bank for International Settlement (BIS), “Our economies have thus become increasingly vulnerable to a possible breakdown in the payments system.”<sup>37</sup>

If it is not desirable to rely largely on short-term credit, then the more desirable thing to do would be to rely on long-term borrowing and equity. Of these two, equity financing is preferable because it would introduce greater health in the economy through a more careful scrutiny of the projects financed.<sup>38</sup> A number of world-renowned scholars like Henry Simons, Hyman Minsky, Charles Kindleberger, Joan Robinson, G.L. Bach, and Kenneth Rogoff have hence concluded that an economy where there is greater reliance on equity would tend to be more stable than a debt-based economy.<sup>39</sup>

<sup>35</sup> See the BIS Triennial Central Bank Survey on foreign exchange and derivatives market activity in September 2013. Such a survey is conducted by the BIS every three years starting from 1980.

<sup>36</sup> World merchandise trade (imports plus exports) amounted to \$4,274.6 billion in 2013 (International Monetary Fund online data base). The average value of the daily world merchandise trade was thus only \$ 11.71 billion in 2013.

<sup>37</sup> BIS Press Release, 22 June 1994, p.3.

<sup>38</sup> See IMF, World Economic Outlook, May 1998, p.82.

<sup>39</sup> Simons, 1948, p.320; Minsky, 1975; see also the summary of Minsky’s argument cited by Joan Robinson, December 1977, p.1331; Kindleberger, 1978, p.16; Bach, 1977, p.182; and Rogoff, fall 1999, pp.211-46.

## CONCLUSION

Thus it may be seen that greater reliance on equity financing has to be an indispensable part of the strategy of any system which wishes to actualize the humanitarian goals of need fulfilment, full employment, equitable distribution of income and wealth, and economic stability. The reason why capitalism has not been able to realize these goals effectively is not because its goals are not humanitarian or the people in capitalist countries do not have the will and the resources needed for this purpose. The primary reason is the conflict that exists between its goals and its strategy. The goals are humanitarian, originating from its spiritual values, while the strategy is social-Darwinist, based on the concept of survival of the fittest. It relies primarily on the rate of interest for allocating financial resources. This gives an edge to the rich and leads to not only concentration of wealth but also a rise in conspicuous and wasteful consumption, thereby hurting the realization of long-term social goals. In addition the absence of risk-sharing contributes to excessive lending which is one of the major causes of financial crises and the prevailing instability in the international financial markets. Mills and Presley are, therefore, right in concluding that:

“There are sufficient grounds to wish that, in hindsight, the prohibition of usury had not been undermined in Europe in the sixteenth century. More practical wisdom was embodied in the moral stand against usury than was then realized”.<sup>40</sup>



<sup>40</sup> Mills and Presley, 1999, p.120.

## CHAPTER THREE

### BANKS WITHOUT INTEREST: IS IT CONCEIVABLE?

The previous two chapters addressed the questions of whether Islam has really prohibited interest and whether there is a strong socio-economic rationale behind this prohibition. This leaves unanswered the third question of whether it is possible to establish an efficient financial system in modern times without the intermediation of interest. A number of people, including some Muslims, may give a negative reply. They may feel that even though there are a number of ills associated with interest, these need to be tolerated because it may not be possible to organize a financial system without interest. Their key argument is that the rate of interest is a price and, like all other prices, it plays a crucial role in the supply of, and demand for, financial resources in any economy. If interest is abolished, what will, then, be the mechanism for mobilizing and allocating financial resources?

There can be no difference of opinion on the need for a realistic market price to mobilize the surplus savings from savers and to allocate them among users. There can, however, be a difference of opinion on which price is most suitable if the objective is to actualize the humanitarian goals of society, including need-fulfilment, full employment, equitable distribution of income and wealth, and economic stability.

As argued in the previous chapter, interest-based financial intermediation frustrates the optimum realization of these

humanitarian goals. The relatively easy availability of credit promotes living beyond means and does not only accentuate speculation in the financial market, macroeconomic imbalances and financial instability, but also squeezes the availability of resources for need-fulfilment, saving and productive investment. Lower growth in saving joins hands with structural rigidities and other socio-economic factors to contribute to slower growth in investment, output and employment.

Islam, therefore, prohibits interest, like other major religions (Hinduism, Judaism and Christianity). This should help promote greater reliance on equity. However, while Islam encourages equity financing, it also allows credit but only for the purchase of real goods and services, and not for speculation, through its sales – and lease-based modes of financing (to be discussed later). Thus, while financial intermediation in an Islamic economy would be largely on the basis of profit-and-loss sharing (PLS) modes, credit would also play a role.

### **Profit-and-Loss Sharing (PLS) Modes of Financing**

The most desirable forms of Islamic financing are the PLS modes of *mudārabah* (commenda)<sup>41</sup> and *mushārahah* (partnership).<sup>42</sup> In

41 *Mudārabah* (commenda) refers to an agreement between two or more persons whereby one or more of them provide finance, while the others provide management. The purpose is to undertake trade, industry or service with the objective of earning profit. The profit may be shared by the financiers and the managers in any agreed proportion. The loss must, however, be borne only by the financiers in proportion to their share in total capital. The loss of the manager lies in having no return for his /her effort.

42 *Mushārahah* (partnership): is also an agreement between two or more persons. However, unlike *mudārabah*, all of the partners contribute finance as well as entrepreneurship and management, though not necessarily equally. Their share in profits can be in accordance with the agreement but the share in losses must be in proportion to their share in capital.

both of these forms, the financier makes the funds available, not as a lender, but rather as an investor. He shares in the profit or loss and is not assured of a positive rate of return irrespective of the ultimate outcome of business. Losses must be shared by him in proportion to his share in the total financing while profits may be shared in any mutually-agreed ratio.<sup>43</sup> His liability, however, remains limited to the extent of financing provided by him and no more.

Since the shares of joint stock companies embody the PLS principle, they are also acceptable. The presence of a well-organized and properly regulated stock market may enable investors to dispose of such stocks whenever they desire – an advantage which *mudārabah* and *mushārahah* financing may not be able to offer. The shares of joint stock companies may also serve as one of the alternatives to interest-bearing government and corporate bonds.

### **Historical Evidence**

From the very early stages in Islamic history, Muslims established a financial system without interest for mobilizing resources to finance productive activities. This was done by using the PLS modes of *mudārabah* and *mushārahah*. According to Professor Udovitch, these modes helped mobilize the “entire reservoir of monetary resources of the medieval Islamic world” for financing agriculture, crafts, manufacturing and long-distance trade. They

43 According to the Shafi’i school, even the profits should be shared in proportion to capital contributions. This is because it is assumed that the contribution of skill and management is difficult to measure and that labour will be contributed equally. However, if two partners contribute to the capital and only one of them contributes to work then, even according to the Shafi’i school, the working partner’s share in the profit may be higher.

were used not only by Muslims but also by Jews and Christians<sup>44</sup> to the extent that interest-bearing loans and other overly usurious practices were not in common use.<sup>45</sup>

According to Professor Goitein, breach of the Jewish, Christian and Islamic law against interest was found “only once in the record of a judgement, even though an unusually large amount of Jeniza documents deal with credit.”<sup>46</sup> Professor Schatzmiller has also concluded that financial capital was developed during the early period by a considerable number of owners of monetary funds and precious metals, without the supposed interdiction of *ribā*, usury, hampering it in any way”.<sup>47</sup>

Financiers were known in the early Muslim history as *sarrāfs*. By the time of the ‘Abbasid Caliph al-Muqtadir (295-320 AH/908-933AC), they had started performing most of the basic functions of modern banks.<sup>48</sup> They had their own markets, something akin to the Wall Street in New York and the Lombard Street in London, and fulfilled most of the banking needs of commerce, industry and agriculture within the constraints of the then-prevailing technological environment.<sup>49</sup> However, since these were not banks in the technical modern sense of the term, Professor Udovitch has preferred to call them “bankers without banks.”<sup>50</sup>

The extensive mobilization of savings and their accessibility to businessmen provided a great boost to the growth of output and

44 Udovitch, 1970, pp.180 and 261.

45 Udovitch, 1981, p. 257, see also p.268.

46 Goitein, 1967, pp.235 and 250 respectively. See also Goitein, 1966, pp.271-274.

47 Schatzmiller, 1994, p.102

48 Fischel, 1992.

49 Dūrī, 1986, p. 898.

50 Udovitch, 1981.

trade from Morocco and Spain in the West, to India and China in the East, Central Asia in the North, and Africa in the South. This is clearly indicated not only by the available historical documents but also by the Muslim coins of seventh to eleventh centuries which have been found in different parts of Russia, Finland, Sweden, Norway, the British Isles, and Iceland – countries which were on the outskirts of the then Muslim world.<sup>51</sup>

### **Sales-Based Modes of Financing**

Due to a number of factors, the Muslim world lost its technological and economic vitality.<sup>52</sup> Hence a number of Islamic institutions, including the Islamic system of financial intermediation, became displaced by Western institutions. However, the independence of Muslim countries, has led to the revival of Islam and there is an ongoing endeavour to gradually reinstate most of the lost institutions, the Islamic financial system being one of them.

This has brought into focus the question of whether these methods can once again play the same invigorating role in accelerating investments and trade and promoting healthy growth as they did in the past. There is no rationale to believe otherwise. The technological advancements that have taken place since then – faster means of transport and communications, better accounting and auditing techniques, and the information technology – can only make the use of these methods relatively easier as compared with the past. They can help in maintaining proper records, calculating costs and profits more accurately, and ensuring greater transparency, checks and controls.

51 Kramers, 1952, p.100, see also Chapra, 2000, pp.193-252.

52 For a discussion of these factors, see Chapra, 2008.

It is not, however, possible for the *mudārabah* and the *mushārah* forms of financing to be amenable to all kinds of financial needs. Since the *Sharī'ah* is realistic and wishes to fulfil all essential financial needs without compromising the realization of socio-economic goals, it has also allowed a number debt-creating sales – and lease-based modes of financing. These are all linked to trade in real goods and services and are intended to enable a person to have access to the goods and services he needs without getting involved in interest. They are all less risky than the profit-and-loss sharing modes. The most well-known of these are *murābahah*<sup>53</sup>, *ijārah* (leasing), *salam*<sup>54</sup>, *istisnā'*<sup>55</sup> and *sukuk*.<sup>56</sup> These techniques, along with *mudārabah* and *mushārah*, have together the ability to fulfil all the necessary financial needs of both the public and the private sectors.

53 *Murābahah* (also called *bay' mu'ajjal*) refers to a sales agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within a specified time frame, either in instalments or lump sum. The seller bears the risk until the goods have been delivered to the buyer.

54 *Salam*: refers to a sales agreement whereby full payment is made in advance against an obligation to deliver the specified fungible goods at an agreed future date. This is not the same as speculative forward sale because full, and not margin, payment is required. Under this arrangement the seller, say a farmer, may be able to secure the needed financing by making an advance sale of only a part of his expected output. This may not get him into delivery problems in case of a fall in output due to unforeseen circumstances.

55 *Istisnā'* refers to a sales agreement whereby a manufacturer (contractor) agrees to produce (build) and deliver a certain good (or premise) at a given price on a given date in the future. This, like *salam*, is an exception to the general *Sharī'ah* ruling which does not allow a person to sell what he does not own and possess. However, unlike *salam* (q.v.), the price need not be paid in advance. It may be paid in installments in step with the preferences of the parties, or partly at the front end and the balance later on as agreed.

56 *Sukuk* refers to an innovative financial instrument designed to raise funds by the temporary sale of an income-earning asset along with the associated ownership rights to the buyers until the asset is repurchased by the seller upon the maturity of the period specified in the contract.

Since the rate of return in all these sales-based modes of financing is determined in advance, unlike that in *mudārabah* and *mushārah*, the *Sharī'ah* has laid down certain conditions for their permissibility.<sup>57</sup> These conditions are intended to ensure that the rise in debt does not exceed the growth of the real economy, the financier also bears at least some risk, and the borrower is not exploited. The proper observation of these conditions may not allow any of these techniques to degenerate into a purely financing device resorted to with the intention of circumventing the prohibition of interest.

### Objections

A number of objections are, nevertheless, raised against the revival of these financing techniques in modern times. Some of these objections are:

#### *Moral Decline*

Firstly, it is argued that in modern times when the level of individual morals is uncomfortable, what is the guarantee that the businesses financed by banks will show the correct level of profits? Market forces will themselves tend to take care of this problem to a great extent once the system starts operating. There will not be just one or two businesses borrowing from banks. There will rather be thousands and those who try to cheat will become exposed by the results they declare compared with those who are honest. They will thus hurt their own long-run interest by getting a poor credit rating. This will deprive them of financing in the future, because these ratings will not only

57 These conditions are discussed in the next chapter.

be mutually circulated by banks but will also become publicly available.

Moreover, certain institutional arrangements need to be made to protect the banks and to facilitate their task. These should include the establishment of a number of auxiliary or shared institutions to minimize the risk associated with anonymity, moral hazard, principal/agent conflict of interest, and late settlement of financial obligations. These institutions would enable the financial institutions to obtain reliable information about their clients and to ensure that the funds lent by them to their clients are employed efficiently according to agreement and that the profit declared reflects the true picture of the business. They would also help them receive repayments on schedule and get justice promptly in case of dispute with, or wilful procrastination of payment by, their clients. They would also enable banks to gain liquidity when they need it in situations of liquidity crunch resulting from unforeseen circumstances. The establishment of such institutions would go a long way in providing a favourable environment.<sup>58</sup>

### ***Deposit Erosion***

Secondly, since a number of depositors may tend to be risk averters, it is argued that they may be driven away from banks in a system where there is the prospect of erosion in their deposits through losses incurred by banks. This need not be the case because all deposits would not necessarily share in the profit or loss. Islamic banks will, like their conventional counterparts, have different categories of deposits – demand deposits and

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<sup>58</sup> For a brief list of these institutions and the tasks they would be expected to perform, see Chapra, 1985 and 2008, pp. 174-181 and 15-25 respectively.

different types and maturities of investment deposits. Demand deposits will be guaranteed and will not share in the profit or loss. They will not, thus, be exposed to any risk. It would be desirable to insure them fully by a deposit insurance scheme. Hence, there is no reason to assume that demand deposits may be driven away.

Investment deposits will, however, share in the profit or loss. But it may be possible for banks to minimize the possibility of loss by diversifying their assets portfolios, managing their risks effectively, and building loss-offsetting reserves. It may also be possible for them to offer to their client's different types of investment opportunities, carrying varying degrees of risks, with the object of attracting the deposits of even risk averters.

Nevertheless, the possibility of loss would still remain. If the risk of loss has not reduced investment in businesses and joint stock companies, there is no reason to assume that the risk of loss on investment deposits would reduce such deposits. To the extent that the risk of loss does have an impact, it may exert a healthy influence on banks. It would help introduce greater discipline in the banking business by making the banks more careful in financing their clients. A great deal of the loose financing undertaken by conventional banks on the basis of the false assurance that they will receive the principal with interest may thus get minimized, thereby reducing the possibility of excessive lending which is one of the major causes of financial crises. It would also remove a major source of inconsistency and instability in the conventional banking system arising from their assets being exposed to risk when the deposits corresponding to these assets do not share in the risk. It would also exert a healthy

influence on depositors by motivating them to take greater interest in the affairs of their banks. They would, therefore, demand greater transparency and better management. They would also demand representation of their interest in the bank's board and shareholders' meetings. This may be through different mechanisms, one of which might be the formation of depositors' associations.

### **The Success so far**

The first full-fledged Islamic bank was established in Dubai in March 1975. This was rapidly followed by others. By the end of 2012, Islamic banks had become established in many countries around the world with total deposits of US\$ 471.8 billion and total assets of \$694.5 billion as compared with 77 banks and total deposits and assets of \$90.6 and \$119.7 billion only a decade earlier in 2002. In addition, Islamic windows were established in conventional banks in Muslim as well as non-Muslim countries to attract depositors who wanted to avoid interest. The rapid progress shows that Islamic banking is not only conceivable but also feasible and viable. A report prepared by Dr. Traute Wohlers-Scharf for the Development Centre of the OECD in 1983 confirms that Islamic banks "have attracted hitherto untouched segments of the Muslim population which, for religious reasons, had stayed outside financial circuits". They "have also generated sizable profits for their shareholders and investment depositors. This indicates that the concept of interest-free finance can work in a modern context".<sup>59</sup> What is even more important is that the Islamic financial institutions were able to withstand successfully the international financial crisis of 2008.

<sup>59</sup> Wohlers-Scharf, 1983, pp.11-12.

An equally admirable fact is that there has been a rapid expansion in the volume of theoretical as well as empirical literature available on the subject. The various concepts related to Islamic modes of financing have consequently become better known and more clarified than they were at the start of the Islamic financial movement. The desire to tackle a number of issues faced by Islamic banks has also led to the writing of a number of juristic papers and monographs of excellent quality and to the formulation of juristic decisions involving *ijtihad*. It is not just Muslims but also non-Muslims, and not only Muslim institutions like the Islamic Development Bank, the International Financial Services Board, and the *fiqh* boards of various Islamic banks, but also international organizations like the IMF, the BIS and OECD that are taking a keen interest in the subject. A number of western universities, including the Harvard Law School and Rice University in the U.S. and the Durham and Loughborough Universities in the U.K. have organized lectures and seminars on the subject and initiated teaching programmes leading to the Master's and Ph.D. degrees in Islamic economics and finance. Something that may perhaps have been indirectly responsible for this increasing popularity of Islamic finance is the search for a 'new architecture' for international finance even in the Western world as a result of recurring crises in the international financial system over the last three decades. There seems to be a realization that a system relying more on risk-sharing may be able to curb excessive lending, which is one of the major causes of financial crises, and thereby help reduce the intensity and frequency of these crises. Thus, one can safely state that, on the whole, there has been substantial progress in every direction.

### **Difficulties**

The Islamic financial movement is, however, experiencing some difficulties. Some of these difficulties are of a teething nature – difficulties that were bound to be encountered during the initial phase of an entirely new experiment. These difficulties would undoubtedly be overcome gradually as the banks become richer in experience and larger in size, and have access to the economies of scale that large conventional banks are able to have. Some of their difficulties are due to a lack of proper understanding of the true nature of Islamic banking among the depositors as well as clients, and a lack of proper training among their employees, most of whom come from conventional banks.

The absence of an Islamic financial market makes it difficult for these banks to employ their surplus funds, or to have access to liquidity, in an Islamic manner. They are, therefore, constrained to resort to the conventional money market. Most of the banks do not even have access to a lender of last resort. They are thus forced to keep larger liquidity than what conventional banks would normally keep. This adversely affects their profitability. Shared institutions (like credit rating agencies) do not exist either, thus forcing the banks to perform all the different tasks themselves.<sup>60</sup> This raises their costs. These difficulties have tended to slow down their progress towards the classical Islamic financing techniques of *mudārabah* and *mushārahah*.

### **Conclusion**

The problems that Islamic banks face could have been resolved faster if all the monetary authorities in Muslim countries had

<sup>60</sup> For a list and functions of some of these institutions, see Chapra 2008, pp. 16-25.

played a more positive and helpful role in the creation of an enabling environment for the Islamic financial system. They would have tried to provide a proper legal framework, facilitated the establishment of shared institutions and an Islamic financial market, and made some arrangement for the creation of a lender of last resort. However, things have now changed. Almost all the monetary authorities in Muslim countries have now become favourable as a result of the system's sound rationale, successful operation, and worldwide acceptance. They are now taking a keen interest in the rapid and healthy development of these institutions. Regulation and supervision are also being streamlined to ensure that these institutions have sound management, adequate capital and reserves, proper accounting, auditing and risk management systems, and greater transparency, and that they do not indulge in practices that would tend to sap their strength and credibility. The monetary authorities should not, however, confine their role merely to regulation and supervision. They should also help these institutions to overcome their difficulties, become more authentic, and reduce their reliance on *hiyal* (legal contrivances) that satisfy the form of *Shari'ah* directives but frustrate the realization of the purpose that lies behind them.

Nevertheless, the progress made so far has been reassuring and it is hoped that the progress will be even faster in the future as a result of the serious crisis that the conventional system is now facing. It is also hoped that the system will continue to move more and more in the direction of greater authenticity which is necessary to make the system genuinely Islamic. There can be, no doubt, that the system has a bright future.



## CHAPTER FOUR

### **THE GLOBAL FINANCIAL CRISIS: CAN ISLAMIC FINANCE HELP?**

#### **INTRODUCTION**

The whole world is now in the grip of a financial crisis, which is far more serious than any experienced since the Great Depression. As of September 2008, governments around the world had made available around \$18 trillion to recapitalize banks and to provide guaranties on bank deposits and other financial assets to abate the intensity of the crisis.<sup>61</sup> Nevertheless, there are fears that this crisis may have exposed the world economy to a long period of economic slowdown. There is, hence, a call for a new architecture that would help minimize the frequency and severity of such a crisis in the future.

#### **PRIMARY CAUSE OF THE CRISES**

It is not possible to design a new architecture without first determining the primary cause of the crisis. The generally recognized most important cause of almost all crises has been excessive and imprudent lending by banks. This raises the question of what makes it possible for banks to resort to such an unhealthy practice which does not only destabilize the financial system but is also not in their own long-run interest. There are three factors that make this possible. One of these is the

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61 United Nations, 2009

inadequate market discipline in the financial system resulting from the absence of profit and loss sharing (PLS). The second is the mind-boggling expansion in the size of derivatives, particularly credit default swaps (CDSs), and the third is the “too big to fail” concept which tends to give an assurance to big banks that the central bank will definitely come to their rescue and not allow them to fail.<sup>62</sup>

The false sense of immunity from losses that all these factors together provide, has introduced a fault line in the financial system. Banks do not, therefore, undertake a careful evaluation of the loan applications. This leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, and to an unsustainable rise in asset prices, living beyond means, and speculative investment. Unwinding later on gives rise to a steep decline in asset prices, and to financial fragility and debt crises, particularly if there is overindulgence in short sales. Jean Claude Trichet, President of the European Central Bank, has rightly pointed out that “a bubble is more likely to develop when investors can leverage their positions by investing borrowed funds”.<sup>63</sup>

### **The Subprime Mortgage Crisis**

The subprime mortgage crisis in the grip of which the US had become entangled in 2008/9, is a classical example of excessive and imprudent lending. Securitization or the “originate-to-distribute” model of financing has played a crucial role in this. The creation of collateralized debt obligations (CDOs) by mixing prime and subprime debt made it possible for mortgage

<sup>62</sup> Mishkin, 1997, pp.61-62

<sup>63</sup> Trichet, 2005, p.4.

originators to pass the entire risk of default of even subprime debt to the ultimate purchasers who would have normally been reluctant to bear such a risk. Mortgage originators had, therefore, less incentive to undertake careful underwriting<sup>64</sup>. Consequently loan volume gained greater priority over loan quality and the amount of lending to subprime borrowers and speculators increased steeply. According to Mr. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, “far too much of the lending in recent years was neither responsible nor prudent. ... In addition, abusive, unfair, or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly”.<sup>65</sup> The check that market discipline could have exercised on the serving of self-interest did not come into play. Even the supervisors failed to perform their task effectively by not taking serious notice of the unfair practices at an early stage and nipping them in the bud.

The result is that a number of banks either failed or had to be bailed out or nationalized by the governments in the US, the UK, Europe and a number of other countries. This created uncertainty in the market and led to a credit crunch, which made it hard for even healthy banks to find financing. There has been a lurking fear that this might be only the tip of the iceberg and a lot more may follow if the crisis causes a prolonged recession and leads to defaults on the part of credit card institutions, corporations, and derivatives dealers.

When there is excessive and imprudent lending and lenders are not confident of repayment, there is an excessive resort to derivatives like credit default swaps (CDSs) to seek protection

<sup>64</sup> Mian and Sufi, 2008, p.4; and Keys, et. al., 2008.

<sup>65</sup> Bernanke, 2008, p.1

against default. The buyer of the swap (creditor) pays a premium to the seller (a hedge fund) for the compensation he will receive in case the debtor defaults. If this protection had been confined to the actual creditor, there may not have been any problem. What happened, however, was that hedge funds sold the swaps not to just the actual lending bank but also to a large number of others who were willing to bet on the default of the debtor. These swap holders, in turn, resold the swaps to others. The whole process continued several times. While a genuine insurance contract indemnifies only the actually insured party, in the case of CDSs there were several swap holders who had to be compensated. This accentuated the risk and made it difficult for the hedge funds and banks to honour their commitments. The notional amount of all outstanding derivatives (including CDSs of \$57.3 trillion) was estimated by the Bank for International Settlements (BIS) to be \$683 trillion in June 2008, more than 12 times the size of the world GDP of \$54.3 trillion in 2007.<sup>66</sup> No wonder George Soros described derivatives as “hydrogen bombs”, and Warren Buffett called them “financial weapons of mass destruction”.

### **THE ISLAMIC FINANCIAL SYSTEM**

One of the most important objectives of Islam is to realize greater justice in human society. According to the Qur’an, a society where there is no justice will ultimately head towards decline and destruction (Al-Qur’an, 57:25). Justice requires a set of rules or moral values, which everyone accepts and faithfully complies with. The financial system may be able to promote justice if, in addition to being strong and stable, it satisfies at

<sup>66</sup> BIS, November 2008, p. 20; and World Bank, 2008.

least two conditions based on moral values. One of these is that the financier should also share in the risk so as not to shift the entire burden of losses to the entrepreneur, and the other is that an equitable share of financial resources mobilized by financial institutions should become available to the poor to help eliminate poverty, expand employment and self-employment opportunities and, thus, help reduce inequalities of income and wealth.

To fulfill the first condition of justice, Islam requires both the financier and the entrepreneur to equitably share the profit as well as the loss. For this purpose, one of the basic principles of Islamic finance is: “No risk, no gain”. This should help introduce greater discipline into the financial system by motivating financial institutions to assess the risks more carefully and to effectively monitor the use of funds by the borrowers. The double assessment of risks by both the financier and the entrepreneur should help inject greater discipline into the system, and go a long way in reducing excessive lending.

Islamic finance should, in its ideal form, help raise substantially the share of equity and profit-and-loss sharing (PLS) in businesses. Greater reliance on equity financing has supporters even in mainstream economics. Prof. Rogoff of Harvard University states that in an ideal world equity lending and direct investment would play a much bigger role (Rogoff, 1999, p. 40).

Greater reliance on equity does not necessarily mean that debt financing is ruled out. This is because all the financial needs of individuals, firms, or governments cannot be made amenable to equity and PLS. Debt is, therefore, indispensable, but should *not* be promoted for nonessential and wasteful consumption and unproductive speculation. For this purpose, the Islamic

financial system does not allow the creation of debt through direct lending and borrowing. It rather requires the creation of debt through the sale or lease of real assets by means of its sales – and lease-based modes of financing (*murabahah*, *ijarah*, *salam*, *istisna* and *sukuk*). The purpose is to enable an individual or firm to buy now the urgently needed real goods and services in conformity with his/her ability to make the payment later. It has, however, laid down a number of conditions, some of which are:

1. The asset which is being sold or leased must be *real*, and not imaginary or notional;
2. The seller or lessor must own and possess the goods being sold or leased;
3. The transaction must be a genuine trade transaction with full intention of giving and taking delivery; and
4. The debt cannot be sold and thus the risk associated with it must be borne by the lender himself.

The first condition will help eliminate a large number of derivatives transactions which involve nothing more than gambling by third parties who aspire to claim compensation for losses which have been actually suffered only by the principal party and not by them. The second condition will help ensure that the seller (or lessor) also shares a part of the risk to be able to get a share in the return. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risk. This condition also puts a constraint on short sales, thereby removing the possibility of a steep decline in asset prices during a downtown. The *Shari'ah* has, however, made

an exception to this rule in the case of *salam* and *istisna* where the goods are not already available in the market and need to be produced or manufactured before delivery. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion.

The third and the fourth conditions will not only motivate the creditor to be more cautious in evaluating the credit risk but also prevent an unnecessary explosion in the volume and value of transactions. This will prevent the debt from rising far above the size of the real economy and also release a substantial volume of financial resources for the real sector, thereby helping expand employment and self-employment opportunities and the production of need-fulfilling goods and services. The discipline that Islam wishes to introduce in the financial system may not, however, materialize unless the governments reduce their borrowing from the central bank to a level that is in harmony with the goal of price and financial stability.

One may raise an objection here that all these conditions will perhaps end up shrinking the size of the economy by reducing the number and volume of transactions. This is not likely to happen because a number of the speculative and derivatives transactions are generally known to be zero-sum games and have rarely contributed positively to total real output. Hence a decline in them is also not likely to hurt the real economy. While a restriction on such transactions will cut the commissions earned by the speculators during an artificially generated boom, it will help them avert losses and bankruptcy that become unavoidable during the decline and lead to a financial crisis.

The injection of a greater discipline into the financial system may tend to deprive the subprime borrowers from access to credit. Therefore, justice demands that some suitable innovation be introduced in the system to ensure that even small borrowers are also able to get adequate credit. Such borrowers are generally considered to be subprime and their inability to get credit will deprive them from realizing their dream of owning their own homes and establishing their own microenterprises.

There is no doubt that a number of countries have, established special institutions to grant credit to the poor and lower middle class entrepreneurs. Even though these have been extremely useful, there are two major problems that need to be resolved. One of these is the high cost of finance ranging from 30 to 84 percent in the interest-oriented microfinance system.<sup>67</sup> This causes serious hardship to the borrowers in servicing their debt. No wonder, the Minister of Finance for Bangladesh described microcredit interest rates in that country as extortionate in an address he delivered at a microcredit summit in Dhaka in 2004.<sup>68</sup> It is, therefore, important that, microcredit is provided to the very poor on a humane interest-free basis (*qard hasan*). This may be possible if the microfinance system is integrated with *zakah* and *awaqf* institutions. For those who can afford to bear the cost of microfinance, it would be better to popularize the Islamic modes of profit-and-loss sharing and sales – and lease-based modes of finance not only to avoid interest but also to prevent the misuse of credit for personal consumption.

Another problem faced by microfinance is that the resources at the disposal of microfinance institutions are inadequate.

<sup>67</sup> Ahmed, 2007; Fernando, 2006; Sharma, 2002; Mannan, 2007.

<sup>68</sup> See Fernando, 2006, p.1.

This problem may be difficult to solve unless the microfinance sector is scaled up by integrating it with the commercial banks. Commercial banks do not generally lend to small borrowers because of the higher risk and expense involved in such financing. It is, therefore, important to reduce their risk and expense. This may be done partly by a subsidy from the *zakah* and *awaqaf* funds for those borrowers who are eligible for *zakah*.

Thus we can see that the Islamic financial system is capable of minimizing the severity and frequency of financial crises by getting rid of the major weaknesses of the conventional system. It introduces greater discipline into the financial system by requiring the financier to share in the risk. It links credit expansion to the growth of the real economy by allowing credit primarily for the purchase of real goods and services which the seller owns and possesses and the buyer wishes to take delivery. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby ensuring that he evaluates the risk more carefully. In addition, Islamic finance can also reduce the problem of subprime borrowers by providing credit to them at affordable terms. This will save the trillions that are spent after the crisis to bail out the rich bankers. These do not, however, help the poor because their home may have already become subject to foreclosure and auctioned at a give-away price.

The problem is that Islamic finance is still in its infancy and shares a very small proportion of international finance. In addition, it does not genuinely reflect the ethos of Islamic teachings. The use of equity and PLS is still very small while that of debt-creating modes is preponderant. Moreover, even in

the case of debt-creating modes, all the conditions laid down by the *Shari'ah* are not being faithfully observed by the use of legal stratagems (*hiyal*). This is partially due to a lack of proper understanding of the ultimate objectives of Islamic finance, the non-availability of trained personnel, and the absence of a number of shared or support institutions that are needed to minimize the risks associated with anonymity, moral hazard, principal/agent conflict of interest, and late settlement of financial obligations. The system is, thus, not fully prepared at present to play a significant role in ensuring the health and stability of the international financial system. It is, however, expected that the system will gradually gain momentum with the passage of time and complement the efforts now being made internationally for promoting the health and stability of the global financial system.

### **Concluding Remarks**

Since the existing architecture of the conventional financial system has existed for a long time, it may perhaps be too much to expect the international community to undertake a radical structural reform of the kind that the Islamic financial system envisages. However, the adoption of some of the elements of the Islamic system, which are also a part of the western heritage, is indispensable for ensuring the health and stability of the global financial system. These are:

1. The proportion of equity in total financing needs to be increased and that of debt reduced.
2. Credit needs to be confined primarily to transactions that are related to the real sector so as to ensure that credit

expansion moves more or less in step with the growth of the real economy and does not promote destabilizing speculation and gambling

3. Leverage needs to be controlled to ensure that credit does not exceed beyond the ability of the borrower to repay.
4. If the debt instruments, and in particular collateralized debt obligations (CDOs), are to be sold, then there should be full transparency about their quality so that the purchaser knows exactly what he is getting into. It would also be desirable to have the right of recourse for the ultimate purchaser of the CDOs so as to ensure that the lender has incentive to underwrite the debt carefully.
5. While there may be no harm in the use of credit default swaps to provide protection to the lender against default, it needs to be ensured that the swaps do not become instruments for wagering. Their protective role should be confined to the original lender only and should not cover the other purchasers of swaps who wish to wager on the debtor's default. For this purpose the derivatives market needs to be properly regulated to remove the element of gambling in it.
6. All financial institutions, and not just the commercial banks, need to be properly regulated and supervised so that they remain healthy and do not become a source of systemic risk.
7. Some arrangement needs to be made to make credit available to subprime borrowers at affordable terms to enable them to buy a home and to establish their own

microenterprises. This will help save the financial system from crises resulting from widespread defaults by such borrowers.



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**ISLAMIC DAWAH MOVEMENT**  
*of Southern Africa (IDM)*

**THE ISLAMIC DAWAH MOVEMENT  
OF SOUTHERN AFRICA (IDM)**

**Introduction:** IDM is primarily involved in promoting the message of Islam to all the people of Southern Africa. With humble beginnings in 1977, it has now grown to be one of the largest dawah organizations in the country and the Southern African region, with over 35 years of experience, expertise and professionalism backing it.

**The Dawah Network Unit** is the largest in the sub-continent, with scores of Islamic Centres under its portfolio and over 50 duaat employed. The IDM is continuously building Masaajid, classroom blocks, boreholes, Imaam's quarters and clinics in Southern Africa. This Unit conducts a host of dawah outreach programmes continuously throughout the year.

**The Human Resource Development Unit** has assumed sub-continental proportions, with the organization of major workshops, seminars and in-service training, incorporating the Southern Africa region; on fiqh, dawah, leadership and management, socio-political, and economic issues; often in conjunction with other international and regional organizations.

## THE MISSION OF IDM

The mission of IDM is to promote the message of the unity of God to all the people of Southern Africa so that they may achieve their God given potential of excellence and purity; and in this way contribute to the moral, spiritual, social, intellectual and economic growth of the nations as a whole.■

## IDM PUBLICATIONS AND RESEARCH UNIT

IDM Publications and Research Unit is a division of the Islamic Dawah Movement of Southern Africa. The primary thrust of the unit is to search, research and publish selective and relevant topics on Islam especially for the region of Southern Africa. It has published innumerable titles, (books and leaflets) as well as translations of the Quran, in 3 major local languages, *Alhamdulillah*. The unit concentrates on already published works, which are out of print, but are relevant to the region and in keeping with our aims and objectives. IDM has published titles primarily in English. However, its publications include titles in various local languages including Xhosa, Zulu, Afrikaans, Oshiwambo and Burundi languages.

A major objective of this Unit, through its publications, is to eliminate ambiguity and misconceptions of certain issues within the value system of Islam; hoping thereby to present the real and authentic Islam to both the Muslims and Non-Muslims alike.

**The Publications and Research Unit** is playing a significant role in the making of a truly “Iqraa” Community in Southern Africa. This Unit researches and publishes, for free distribution, topics relevant to the Southern African scenario. It incorporates the bookshop and the translation of the Quran into 3 major languages of Southern Africa.

**The Education and Training, Skills Development, and Capacity Building Unit:** Running as a thread and interspersed with the other activities is the significant educational and education-related activities grouped together under the banner of the Education and Training, Skills Development and Capacity Building Unit. Under this unit, scores of scholarships are made available; and various different types of education-related grass-roots based activities are conducted on an on-going basis. These activities include computer classes, ABET (Adult Basic Education Training) classes, pre-schools, sewing and embroidery classes, home based gardening skills programme, in-service training, Train the Trainers courses, adult Islamic classes, and youth training camps.

**The Welfare Unit** encompasses the feeding of hundreds of children daily at Madaaris, building of clinics and boreholes, and a host of other welfare-related activities.

**Conclusion:** IDM is currently in a favourable position to effectively enhance and accelerate the Islamisation process in the Southern African region. *Alhamdulillah*.■

The IDM Publications and Research Unit intends to continue to publish a variety of topics on Islam that would primarily aid in a better understanding of the true Islam amongst the people of Southern Africa, and thereby help to catalyse the process of Islamisation regionally and globally. The overall aim and objective of this Unit is to present Islamic principles and values to Muslims and Non-Muslims in order to help them understand this religion and way of life, which advocates unity, justice, brotherhood, tolerance and peace, which is Islam■

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