PROHIBITION OF INTEREST: DOES IT MAKE SENSE?

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Towards a Just Monetary System (Leicester, U.K.: The Islamic Foundation, 1985).

Objectives of the Islamic Economic Order (Leicester, U.K.: The Islamic Foundation, 1977)

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FOREWORD

A number of people often wonder why Islam has also, like some other major religions, prohibited interest. They also wonder whether it is feasible for Muslims to abolish interest in modern times and to establish a financial system without interest. Dr. Chapra has tried answer these questions in two brief papers written in a simple style to make them easily understandable by even the layman. Those who desire a more elaborate answer may wish to read the extensive literature produced on the subject by him and other scholars during the last quarter century.

These papers were first published in the October1992 and August 1993 issues of *Ahlan wa Sahlan*, which is the in-flight magazine of the Saudi Arabian Airlines. They were highly appreciated because of the convincing manner in which they throw light on an important aspect of Islamic teachings. The Islamic Da'wah Movement, therefore, requested Dr. Chapra to revise and update them for publication in the form of a booklet. He kindly acceded to our request and did the needful.

Dr. Chapra (1933-), now a Saudi citizen, is presently serving as Research Advisor at the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB). Before joining IRTI in November 1999, he worked at the Saudi Arabian Monetary Agency (SAMA), from where he retired as Senior Economic Advisor after a long service of 35 years. He has also taught in the United States at the Universities of Wisconsin and Kentucky and worked in Pakistan at the Institute of Development Economics and the Islamic Research Institute. He has made seminal contributions to Islamic Economics and Finance over more than three decades in the form of 10 books and monographs and more than 70 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 Studies, both in 1990.

I take this opportunity to extend my grateful thanks to Sh. Muhammad Rashid for the secretarial assistance provided by him in the preparation of these papers.

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PROHIBITION OF INTEREST: DOES IT MAKE SENSE?*

by
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It is not Islam alone which has prohibited interest. Other major religions like Judaism, Christianity and Hinduism have also done the same. The Bible disapproves of interest severely and makes no distinction between usury and interest.[1] Those who took interest were branded as wicked[2] and could not, according to the Third Lateran Council (1179), be admitted to communion or receive Christian burial.[3] The Qur'an also prohibits interest strictly and declares those who take interest to be at war with God and His Prophet (2:279). This raises the question of why there is such a harsh verdict against interest in all these religions. Is there any sound rationale behind it?

Those who are against the prohibition assume that interest was prohibited mainly because of the injustice it inflicted on the poor, who were charged an exorbitant rate of interest for loans

* This paper is a significantly revised and updated version of the paper, "A Matter of Interest: The Rationale of Islam's Anti-Interest Stance," published in the October 1992 issue of *Ahlan wa Sahlan*, pp.38-41.

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1 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.

2 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.

3 Johns, *et.al,* p.551.

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. During the Prophet's days, peace and blessings of God be on him, borrowing was not undertaken by the poor. This is because by the end of the Prophet's life, when the prohibition of interest became strictly enforced, the needs of the poor were taken care of either by the rich or the *bayt al-mal* (the Public Treasury). Therefore, the poor did not have to borrow to fulfil their needs.

This leads to the question of who borrowed and why? Borrowing was resorted to primarily by tribes and rich traders who operated as large informal partnership companies to conduct large-scale trade. This was necessitated by the prevailing circumstances. 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'an to be the main mission of all God's messengers (57:25).

Justice, however, needs to be understood in a much wider context. Confining it merely to trade may not be able to take us far enough. Justice demands that the resources provided by God to mankind as a trust must be utilized in such a manner that the universally-cherished humanitarian goals of general need fulfillment, 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 can 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 optional 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.[4]

1. NEED FULFILLMENT

Financial intermediation on the basis of interest tends to allocate financial resources among borrowers primarily on the basis 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

[4] The subject has been discussed in greater detail by the author in Chapra, 1985, pp.19-29 and 107-145; 1992, pp. 327-34; and 2000 a and b.

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 is assumed, will not go 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 defence buildup and white elephant projects. This does not only accentuate macroeconomic and external imbalances, but also squeezes the resources available for need fulfillment and development. This explains why even the richest countries in the world like the United States have been unable to fulfil the essential needs of all their people in spite of their desire to do so and the abundant resources at their disposal.

2. FULL EMPLOYMENT

The living beyond means which the interest-based financial intermediation has the tendency to promote through the easy availability of credit, has led to a decline in savings in almost all countries around the world. Gross domestic saving as a percent of GDP has registered a worldwide decline over the last quarter century form 26.2 percent in 1971 to 22.3 percent in 1998. The decline in industrial countries has been from 23.6 percent to 21.6 percent. 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 from 34.2 percent to 26.0 percent over the same period.[5] There are a number of reasons for this. One of these is the rise in consumption by both the public and the private sectors. This saving shortfall has been responsible for persistently high levels of real interest rates. This has led to lower rates of rise in investment, which have joined hands with structural rigidities and some other socio-economic factors to reduce the rates of growth in output and employment.

5 Figures have been derived from the Table on "Consumption as percent of GDP" in IMF, 2000 Yearbook, pp.177-79.

Unemployment has hence become one of the most intractable problems of most countries, including those in the rich industrial world. Unemployment stood at 9.2 percent in the European Union in 1999, more than three times its level of 2.9 percent in 1971-73[6] It may not be expected to fall significantly below this level in the near future because the real rate of growth in these countries has been 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.[7]

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 are required to share in the risks and rewards of financing and credit is made available primarily for real goods and services, which the Islamic system tries to ensure, the banks will be more careful in lending and credit expansion will be in step with the growth of the economy. Unproductive and speculative spending may consequently decline and more resources may become available for productive investment and development. This

6 OECD, *Economic* Outlook, December 1991, Table 2, p.7; and June 2000, Table 22, p.266.

7 A question may be raised here about the current 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 lead to higher growth, a rise in employment opportunities, and a gradual decline in unemployment.

3. 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."[8] The reason is, as already indicated, interest-based financial intermediation tends to rely heavily on collateral and to give inadequate consideration to the strength of the project or the ultimate use of financing. Hence, while deposits come from a cross-section of the society, their benefit goes largely to the rich. 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".[9] 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."[10]

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

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[8] Bigsten, 1987, p.156.

[9] Mishan, 1971, p.205.

[10] Morgan Guarantee Trust Company of New York, 1987, p.7.

make to output, employment and need fulfillment 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.[11] Other small-loan programmes have yielded similar results in several countries. Nevertheless, it may be desirable to arrange insurance of small loans to provide protection to financiers against fraud and mismanagement.

4. 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, is the erratic behaviour of interest rates.[12] The high degree of interest rate volatility injects great uncertainty into the investment 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 a steep rise in highly leveraged short-term debt, which plays an important role in destabilizing financial markets.

One may wish to pause here to ask why a rise in short-term debt should accentuate instability. 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

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11 *The Economist,* 16 February 1985, p.15.

12 Friendman, 1982, p.4.

services, an excess of it tends to get diverted to speculation in the foreign exchange, commodity and stock markets.

The 1997 East Asia crisis has clearly demonstrated this. The Eastern tigers had healthy fiscal polices 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 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 loans 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 which 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.[13] If the Federal Reserve had not come to its rescue, the whole world economy could 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 even in the international foreign

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[13] 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. Daily turnover in the international foreign exchange markets was $1,490 billion in April 1998[14], which was 49 times the daily volume of world merchandise trade.[15] This indicates 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."[16]

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.[17] 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.[18]

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 fulfillment, 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

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[14] See Table 1 of the BIS *Press Release* of 19 October 1998 which gives the preliminary results of the foreign exchange survey for April 1998. Such a survey is conducted by the BIS every three years.

[15] World merchandise trade (imports plus exports) amounted to $908.7 billion in April 1998 (IMF, *International Financial Statistics,* November 1998). The average value of the daily world merchandise trade in April 1998 was thus only $ 30.3 billion.

[16] BIS *Press Release*, 22 June 1994, p.3.

[17] See IMF, *World Economic Outlook*, May 1998, p.82.

[18] 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.

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 religious past, 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. This hurts the realization of goals. It also contributes substantially to 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".[19]

[19] Mills and Presley, 1999, p.120.

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BANKS WITHOUT INTEREST: IS IT CONCEIVABLE*?

by
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The article (Prohibition of Interest: Does it Make Sense?) published in a recent issue of *Ahlan wa Sahlan,* indicated the strong economic rationale behind the prohibition of interest by some major religions. Nevertheless, the question that still remains to be answered is about whether there is an alternative to 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 have to be tolerated because they do not find it possible to organize a financial system without interest. Their key argument as 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, how will financial resources get mobilized and allocated?

There can be no difference of opinion on the need for a realistic market price to mobilize the surplus savings form 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 need-fulfillment, full employment, equitable distribution of income and wealth, and economic stability.

As argued in the previous paper, financial intermediation on the basis of interest frustrates the optimum realization of these humanitarian goals. The relatively easy availability of credit promotes living beyond means and does not thereby accentuate only macroeconomic imbalances and financial instability but also squeezes the resources available for need-fulfillment and productive investment. Lower growth in saving joins hands with

* This is a substantially revised and updated version of the paper bearing the same title published in the August 1993 issue of *Ahlan wa Sahlan*, pp.11-14.

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. This should help promote greater reliance on equity. However, while Islam encourages equity financing, it allows credit, but for only real goods and services, and not for speculation, through its sales-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.

MUDĀRABAH AND *MUSHĀRAKAH*

The most desirable forms of Islamic financing are the PLS modes of *mudārabah* (commenda)[20] and *mushārakah* (partnership).[21] In 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, in advance, 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.[22] His liability, however, remains limited to the extent of financing provided by him and no more.

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[20] *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.

[21] *Mushārakah* (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.

[22] According to the Shafi'i school, even the profits should be divided 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

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 *mushārakah* financing may not be able to offer. The shares of joint stock companies may also serve as an alternative 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 on the basis of the PLS modes of *mudārabah* and *mushārakah.* 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 were used not only by Muslims but also by Jews and Christians[23] to the extent that interest-bearing loans and other overly usurious practices were not in common use.[24]

According to 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."[25] 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".[26]

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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.

[23] Udovitch, 1970, pp.180 and 261.

[24] Udovitch.1981, p. 257, see also p.268.

[25] Goitein, 1967, pp.235 and 250 respectively. See also Goitein, 1966, pp.271-274.

[26] Schatzmiller,1994, p.102

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.[27] 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.[28] However, since these were not banks in the technical modern sense of the term, Professor Udovitch has preferred to call them "bankers without banks."[29]

The extensive mobilization of savings and their accessibility to businessmen provided a great boost to the growth of output and 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.[30]

Due to a number of historical circumstances, the Muslim world lost its technological and economic vitality.[31] 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 a longing to gradually reinstate most of the lost institutions, the Islamic financial system being one of them.

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[27] Fischel, 1992.
[28] Duri,1986, p. 898.
[29] Udovitch, 1981.
[30] Kramers, 1952, p.100, see also Chapra, 2000, pp.193-252.
[31] For a discussion of these, see Chapra, 2000, pp.193-252.

This has brought into focus the question of whether these methods can once again play the same invigorating role in accelerating investments 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.

It is not, however, possible for the *mudārabah* and the *mushārakah* forms of financing to be amenable to all kinds of financial needs. Since the *Shari'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 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*[32], *ijārah* (leasing), *salam*[33], and *itisna'*[34]. These techniques, along

32 *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 installments or lump sum. The seller bears the risk for the goods until they have been delivered to the buyer.

33 *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.

34 *Istishnā'* refers to a sales agreement whereby a manufacturer (contractor) agrees to produce (build) and deliver a certain good (or

with *mudārabah and mushārakah*, have together the ability to fulfil all the necessary financial needs of both the public and the private sectors.

Since the rate of return in all these debt-creating sales-based modes of financing is determined in advance, unlike that in *mudārabah* and *mushārakah*, the *Shari'ah* has laid down certain conditions for their permissibility. These conditions are intended to ensure that the financier bears at least some risk and that the borrower's interest is also protected. 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:

(i) Moral Decline

Firstly, it is argued that in modern times when the level of individual morals is deplorable, 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 be mutually circulated by banks but will also become publicly available.

premise) at a given price on a given date in the future. This, like *salam,* is an exception to the general *Shari'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.

Moreover, certain institutional arrangements will need to be made to protect the banks and to facilitate their task. These may include the establishment of a number of auxiliary or shared institutions in the private sector, with the help of the central bank and the commercial banks, to collect data about firms, to determine their credit rating, to evaluate projects, and to audit the accounts of businesses referred to them by banks.[35] Since businesses may not wish to get a poor credit rating or to be exposed to the rigours of audit by such organizations, they may find it in their own self-interest to declare the correct profit.

(ii) Deposit Erosion

Secondly, it may be argued that since a number of depositors may tend to be risk averters, 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 be sharing in the profit or loss. Islamic banks would, like their conventional counterparts, have different categories of deposits – demand deposits and different types and maturities of investment deposits. Demand deposits will be guaranteed and will not hence share in the profit or loss. They will not thus be exposed to any risk. It would be desirable to insure them partly or fully by a deposit insurance scheme. Hence, there is no reason to assume that demand deposits may be driven away.

Investment deposits would, 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 clients different types of

[35] For an elaboration of the nature and role of these institutions, see Chapra, 1985, pp.174-81.

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 tend to make them 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. 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.

THE SUCCESS SO FAR

The first full-fledged Islamic bank was the established in Dubai in March 1975. This was rapidly followed by others. By the end of 1997, more than 176 banks and financial institutions, having total assets of $147.7 billion, had become established around the world. This does not include the profit-and-loss sharing counters that conventional banks have opened in Muslim as well as non-Muslim countries for their customers who wish 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 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".[36]

What is equally admirable is the 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 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 Association of Islamic Banks and the *fiqh* boards of various Islamic banks, but also international organizations like the IMF and the BIS 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 replying more on equity and less on debt may be able to help reduce the intensity and frequency of these crises. Thus one can safely state that on the whole there has been great 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

[36] Wohlers-Scharf, 1983, pp.11-12.

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 the lack of a proper understanding of the true nature of Islamic banking among their depositors as well as their clients, and 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, forced 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 This raises their costs. These difficulties have tended to slow down their progress towards the classical Islamic financing techniques of *mudārabah* and *mushārakah*.

THE SOLUTION

It may have been possible to remove some of these difficulties faster if all the monetary authorities in Muslim countries had played a more positive and helpful role in the evolution of an enabling environment for this 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. The Islamic banks would not have thus been like an embryo struggling to survive in an inhospitable environment without support systems.

What is needed is a change of attitude on the part of monetary authorities of those Muslim countries which are allergic to Islamic finance. They need to take a keen interest in the rapid and healthy development of these institutions. They must regulate them adequately to ensure that they have sound management, adequate capital and reserves, proper risk management systems and greater transparency, and that they do not indulge in practices that would tend to sap their strength and credibility. The central banks should not, however, confine their role merely to regulation and control. They should also help them overcome the difficulties that prevent them form adopting the classical techniques. This is not an option which the central banks may or may not exercise. They owe this to Islam and to the Muslim *ummah*. Islamic banking is undoubtedly more difficult than conventional banking and one would expect that central banks would render to Islamic banks at least as much assistance as the conventional central banks normally provide to their commercial banks for their healthy and sound development.

BRIGHT FUTURE

In spite of these problems the movement for Islamization of banking is on sound footing. The progress made over the last quarter century is itself reassuring. A number of the people involved in the movement are extremely dedicated and competent and are trying to do their utmost to overcome the difficulties that the Islamic banks are facing. There is no reason to doubt that the movement will be able to not only overcome these difficulties but also ensure for itself a bright future.

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