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History of Islamic Banking and Finance

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Abstract: This paper aims to investigate the origins and evolution of Islamic Banking and Finance from the early days of Islam up to the formal establishment of Islamic banks in the sixties of the last century. It also sheds light on the banking practices in the later parts of Islamic history which is an almost un-researched area. It records the existence of interest free lending societies at the end of the 19th century and the situation preceding the development of modern Islamic banks in the second half of the twentieth century. The paper concludes that Islamic banking was an attempt to practice an aspect of economic life in an Islamic way and it first emerged in rural and agricultural economies and nothing to do with the petrodollar or oil boom of the Middle East as usually put forward.

Keywords: Origins of Islamic banking, Development of Islamic banks, Interest-free lending societies, Bayt al-mal, Mit Ghamr, Tabung Haji, IRTI/IDB.

Abstrak: Kertas kerja ini bertujuan menyelidik asal usul dan perkembangan Perbankan dan Kewangan Islam sejak daripada waktu awal Islam sehingga penubuhan rasmi perbankan Islam pada tahun enam puluhan kurun yang lepas. Ia juga memberi penerangan kepada pengamalan perbankan pada zaman terkemudian sejarah Islam, yang mana ada suatu ruang yang hampir tiada kajian. Ia merekodkan kewujudan masyarakat yang mengamalkan pinjaman tanpa faedah pada akhir kurun ke 19, dan keadaan yang mendahului perkembangan perbankan Islam moden pada separuh kedua kurun kedua puluh. Kertas kerja ini menyimpulkan bahawa perbankan Islam ialah sebuah cubaan untuk mengamalkan satu aspek daripada kehidupan ekonomi menurut cara Islam, dan ia mula-mula muncul dalam ekonomi pedalaman dan pertanian, dan tiada kaitan pun dengan petrodollar atau ledakan minyak di Timur Tengah seperti yang kebiasaannya disebut-sebut.

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Kata Kunci: Asal Usul Perbankan Islam, Perkembangan bank Islam, masyarakat pinjam tanpa faedah, Bayt al-mal, Mit Ghamr, Tabung Haji, IRTI/IDB.

1.0 Introduction

Islamic banking and finance is 'the most visible practical achievement' of Islamic economics[1] However, hardly any attempt has been made to investigate its origins and evolution since the early period of Islam. In the literature on the subject, generally, we do not find information about banking and finance before the second half of the twentieth century. Most writers are not aware of the existence of interest-free lending societies at the end of the 19th century and the situation preceding the advent of modern Islamic banks. The present paper aims at filling this void and to remove the misunderstanding that Islamic banking and finance is an exclusive product of the twentieth century. It investigates the origins and development of Islamic banking and finance from the early days of Islam up to the formal establishment of Islamic banks in the sixties of the last century. This paper also provides the earliest record of the establishment of interest- free lending societies by the end of 19th century and semi-banking institutions in the first half of 20th century. It gives an account of the major events before Islamic banking became an alternative to interest-based conventional banks. In the concluding remarks, the paper refutes the allegations by some writers that Islamic banking is a product of identity creation or 'pan-Islamism' and that it was promoted by the oil rich countries of the Middle East.[2]

2.0 Islamic Banking and Finance in Early Islam

Like the conventional banking system, the origins of modern Islamic banking can be traced back to lending and borrowing and financing commercial activities of an earlier period. The city of Makkah where the Qur'an was revealed to Prophet Muhammad (PBUH) had been an international trading center since the pre-Islamic period (Watt, 1953, p. 3). The Makkan people could have founded 'a commercial empire of international dimensions' (Crone, 1987, p.8). Having trade as their main occupation, they needed financing for business purposes. Those having surplus funds advanced capital to businessmen and traders and shared the profit. The Prophet himself engaged in trading before his prophethood and travelled several times with the financial capital of

Khadijah,[3] who extended him finance on *mudarabah* basis as explained below. The caravan headed by Abu Sufyan[4] on the eve of the battle of *al-Badr* consisted largely of capital in partnership with Abu Sufyan and others (Ibn Taymiyah 1963, 19: 195). It may be noted that *mudarabah* was not the only method of business financing. Capital was also extended for other forms of trading like *murabahah, musharakah, salam*, etc.[5]

Under the Islamic system the alternative to charging interest for financing business has been provided by the provision of profit and loss sharing. No one is entitled to any guaranteed profit irrespective of the outcome of the business. Profit is to be shared on the basis of a predetermined ratio, not on a percentage to be earned on the capital supplied. In case of loss, the capital owner bears the capital loss while the working partner bears the loss of his labor, that is, his labor goes 'unrewarded' (Ibn Taymiyah 1963, vol. 30, pp.78, 84, 108-09). This is called a *mudarabah* partnership. The working partner is held responsible if cases of 'moral hazard', sub statement of profit or negligence on his part are proven (ibid., p. 88).

Some rich companions of the Prophet, such as Abbas b. Abd al-Muttalib,[6] Khalid b. al-Walid,[7] Uthman b. Affan,[8] had lending businesses, in the pre-Islamic period, with the people of Makkah and Taif (Ibn al-Jawzi, 1964, vol. 1.). After embracing Islam, they abandoned it. In the Islamic system, lending and borrowing must be without interest. One has to expect its reward from Almighty Allah, the Creator of the rich and the poor. Islam has encouraged such lending and considered it more rewarding than charity (Ibn Majah, 3:500. Hadith No. 2431). No surprise then it was very common among the Muslims. It is also no surprise that the longest verse of the Qur'an is about the documentation of the lending-borrowing transactions (The Qur'an 2: 282). In fact, the Qur'an offers a guideline towards taking the pledge as a surety for repayment of the debt:

> And if you are on a journey and cannot find a scribe, then let there be a pledge taken (mortgaging); then if one of you entrust the other, let the one who is entrusted discharge his trust (faithfully), and let him be afraid of Allah, his Lord. And conceal not the evidence for he, who hides it, surely his heart is sinful. And Allah is All-Knower of what you do. (The Qur'an 2: 283)

There are many instances of the Prophet (PBUH) borrowing from his Companions (al-Nasai, 1986, 7:314. Hadith No. 4683). He also borrowed from the Jews. In fact, when the Prophet died, his shield was with a Jew who had kept it as collateral for a debt (al- Asqalani, 1397H., 1: 279). His borrowing was for his own needs as well as for public purposes. Sometimes he borrowed on the basis of expected revenue from the *bayt al-mal* (public treasury), that is, he would repay when funds were available in the Treasury (Ibid. 5: 256-58).

Individual financing was the practice in the early period of Islam. Due to stringent requirements of the public treasury, no institutional arrangements were made during the Prophet's lifetime for loans and for financing business. However, lending and borrowing was so common that the category of persons indebted (*gharimin*) were prescribed as one of the heads of expenditure of *zakah*: "The alms [i.e. *sadaqat* and *zakah*] are only for the poor and the needy, and those who collect them, and those whose hearts are to be reconciled, and to free the captives and the debtors, and for the cause of Allah, and (for) the wayfarer; a duty imposed by Allah. Allah is Knower, Wise" (the Quran 11:60. Tr. by Pickthal).

With reference to this Qur'anic verse, Dr. Hamidullah (2007, p. 213) observes that Islam not only prohibited interest, but also provided the means to abolish it altogether and in addition, ordered that a part of government revenue be allocated to help the indebted. This provision is inferred from the verse quoted above. He argues that since the poor and the needy have been mentioned in the beginning of the verse, the 'indebted' does not refer to the starving poor. Rather it refers to 'the well-to-do' who are temporarily in need of finance[9] (ibid; Hamidullah, 1962, p.19). This is so because

> Mere prohibition of interest, without providing how to meet the requirements of the needy, has proved useless in all civilizations. Islam was the first to lay down that it is among the first duties of the State to provide interest-free loans for the needy, even well-to-do; and the Qur'an has earmarked this item among the expenditures of the Muslim State. (Ibid. p. 20)

3.0 Formal arrangement of financing in Islam

In the early period of Islam, *bayt al-mal* (the house of finance) or the Public Treasury was the first institution to mark the foundation of formal arrangement of financing. Basically it was a government agency of finance but it also extended loans or investment capital to individuals. It worked as a state bank for the caliph and for the public (ibid.). For example, Umar, the second caliph, extended an amount of 4000 (dirhams) to Hind[10] for business purpose (al-Tabari, 1407H, vol. 2, pp. 576-77). There is another instance of a loan being extended for trading purpose from the public fund. Abu Musa al-Ash`ari (d. between 662 and 672 CE), the governor of Basra, had to dispatch some money to the central treasury in Madinah to be given to the *bayt al-mal*. He gave the amount to Abdullah and Ubaydullah (the two sons of Umar ibn al-Khattab) who intended to travel to Madinah, the capital of the Islamic caliphate. He told them: "You can buy wares from Iraq and sell them in Madinah. Then give the principal to the *amir al-muminin*, and you keep the profit." By purchasing goods in Iraq and selling them in Madinah, they made a profit, and when they paid the principal to Umar, he asked them to surrender both the principal and the profit. Abdullah kept silent but the younger son Obaidullh objected: "Had the principal decreased or been destroyed, we would have guaranteed it. So we are entitled of profit". After a little argument, on the suggestion of an advocate, Umar decided to consider it as a partnership contract and accepted the principal and half of the profit, and the two sons of Umar took the other half of the profit (Malik, 2002, p. 419, report no.1396).

The third caliph, Uthman ibn Affan, also used to provide capital for carrying out business on the basis of *qirad*[11] that is, the condition that the profit be shared (ibid. report no.1397).

Charging interest is prohibited in many social and religious systems, but Islam alone has provided for interest-free lending and made it one of the main responsibilities of the state to arrange payments for indebted persons. In the *Bayt al-mal* (or Government Treasury) there was a special branch for lending and receiving repayments of interest-free loans (Hamidullah, n.d. p. 491). Pointing out to this, Hamidullah (1955, 11) emphasizes: "Islam is not the only religion that has denounced interest on loans in vehement terms (cf. The Qur'an, 2: 275-279, etc.), but it is the only one, to my knowledge, that has provided a way out of the dilemma".

During the Umayyad caliphate the *bayt al-mal* also functioned as the finance house for various purposes such as assistance to persons in need of financing, to those unable to repay the loan, for marriage expenses, as well as loans to farmers for agricultural development. Abu Ubayd (1968, p. 320, report no. 625) reports that the caliph Umar b. Abd al- Aziz[12] wrote to his governor in Iraq to extend financial assistance to deserving people, repay debts of those who borrowed for some genuine reasons and were unable to repay, help every young unwedded woman who wanted to marry but was unable to do so due to lack of money, give loans to all those who had to pay taxes on land that had lost fertility. The repayment period of money given to invest in agriculture ranged from one to two years. Thus, enough time was given to utilize the borrowed money and enjoy the fruits of their labour.

There are reports of buying and selling of *sukuk*[13] representing rationed food. But it was stopped in its infancy because of objections raised by some Companions of the Prophet as it came under the definition of selling something without having it in possession (Malik b. Anas, 2002, p. 391, report no. 1338).

Zubayr ibn al-Awwam[14] showed the way on how to perform banking in the sense of accepting deposits like current accounts in modern banks and utilizing the money in businesses. It is reported that when somebody wanted to deposit money with him as *amanah* (safe-keeping), he would say: "Make it a loan to me"[15] (al-Asqalani, 1397H., vo. 6. P. 328). In this way he got a benefit for himself and gave another benefit to the depositor; he had the permission to use the money and the depositor was guaranteed its return. A similar practice is also reported about the celebrated jurist Abu Hanifah, who had a flourishing business in silk (Siddiqi, 2015, p.15, p. 154). Such precedence, it may be pointed out, paved the path for modern Islamic banks to have an understanding with the depositors that their current accounts shall be loans to the bank.

Mabid al-Jarhi, in a recent article, observes that at present, "Islamic economists propose 16 contracts to replace the classical loan contract. Some are based on partnership in profit and product. Some are based on investment agency and the rest are based on sale and lease arrangements" (al-Jarhi, 2016, p.76). The origins of these contracts go back to the early period of Islam.[16] "Providing such contracts as alternatives to the classical loan contract, and their use in the Islamic world for hundreds of years is perhaps the reason behind the name of "Islamic finance." Otherwise, calling it "Jewish" or Christian finance would have been appropriate" (ibid. note no. 4). It has to be noted that the partnership commitment was only one of the methods of carrying out business. The focus of earlier writers was on *mudarabah* or partnership because they considered it more just and rewarding (Siddiqi, 1981b) and more suitable for Islamic banks than other modes of financing.

3.1 Through Various Stages of History

In Islam, because interest is strictly prohibited, lending and borrowing was without interest. Even money and certain commodities exchanges where interest might have entered, called *riba al-nasiyah* and *riba al-fadl*, were regulated with certain rules.[17] In the early centuries of Islam, available funds were mobilized to finance agriculture, domestic industries, and trading activities through *mudarabah* (sleeping partnership), *musharakah* (profit and loss sharing), *bay salam* (advance payment with deferred delivery), *murabahah* (selling something with mark- up price), etc.[18] A prosperous economy cannot exist without provision of financing for production and trading activities. Chapra remarks:

> To finance their expanding domestic and interactional trade, the Muslim world also developed a financial system, which was able to mobilize the 'entire reservoir of monetary resources of the mediaeval Islamic world' for financing agriculture, crafts, manufacturing and long-distance trade (Udovitch, 1970, pp.180 and 261). Financiers were known as *sarrafs*. By the time of Abbasid Caliph al-Muqtadir (908-932), they had started performing most of the basic functions of modern banks (Fischel, 1992). They had their markets, something akin to the Wall Street in New York and the Lombard Street in London, and fulfilled all the banking needs of commerce, agriculture and industry (Duri, 1986, p. 898). This promoted the use of checks (*sakk*) and letters of credit (*hawala*). The English word 'check' comes from the Arabic term *sakk*. (Chapra 2014, p. 54)

In the later period, when the need for financing further increased, Muslims invented various methods to sustain financing, investment and transfer of money, such as *suftajah*[19], *cash waqf*[20], *bay al-wafa*[21], *bay al-raja'*[22], etc. It is also reported that in the case of procuring loans, some people resorted to certain legal stratagem such as *bay al-inah*[23] and *tawarruq*[24].

Kuran, a vehement critic of Islamic banking and finance, admits: "… early Islamic civilization developed 'impressive financial institutions'. By the tenth century, Islamic law supported credit and investment instruments that were as advanced as their counterparts outside the Islamic world. In fact, they stimulated institutional advances elsewhere, including Western Europe" (2004, pp. x-xi).

It is not possible to give a detailed account of all instruments of lending, financing and transfer of money used in the pre-modern banking period. However, cash *waqf* needs special mention here. It was a kind of Islamic endowment which facilitated 'the flow of funds from those who were able to save to those who needed capital' (Akgunduz, 2009, p. 35). Abu al-Suʿud (in Turkish Ebussuud Efendi, al-Imadi d.1574) reports that the objective of the cash *waqf* would be to lend money to the poor (invariably without interest) and to extend money as capital to working partners on *mudarabah* basis and spend the gain on charity (Abu al-Suʿud, 1997, pp. 29-30). The cash *waqf* especially played a very important role in the economic and financial matters of the Ottoman caliphate. It was 'extremely popular all over Anatolia and the European provinces of the Empire' (Akgunduz, 2009, p. 35).The cash *waqfs* were 'instrumental in the emergence of a legally sanctioned and well-developed money market' (ibid). According to Akgunduz, "Ottoman scholars have been discussing Islamic banking since Suleiman the Magnificent (1574). Islamic banking was known in the Ottoman state as *[al-]Mu'amalah al-Shar'iyyah* which we simply call *murabahah*" (ibid.).

Records are available to show that during the sixteenth century Christians borrowed money from the Treasury (*bayt al-mal*). They also borrowed from their Muslim brethren (Bakhit, 1982, 2:28). There are reasons to believe that Muslims too borrowed from them and from their own people. However, we could not trace any institutional arrangement for this purpose during this period. Incidentally, this was the time when foundations for modern banking were being laid down in Europe along with the maritime trading companies.[25]

Throughout history Muslims never tried to denounce the prohibition of interest in principle, nor reject it in practice. This point is also brought out clearly by Schacht (1936, Vol. III, p. 1150) who says that Muslims 'were always conscious that a direct breach of the prohibition of *riba* (interest) was a deadly sin'. However, instances of certain practices of subterfuge are reported such as *inah* and *tawarruq* contracts which did not come directly as interest payments. Thus, *tawarruq* and *inah* which are used as techniques of financing by some Islamic banks today have their origins in the past as subterfuge to avoid the issue of interest. The only difference is that in the past it was at the individual level and unorganised, and mostly out of compulsion. Now it is used by some financial institutions in an organised way for garnering profits. The techniques, however, were condemned in the past as well as at present by a majority of right thinking people.

In early period of Islam, Muslims were against the practice of interest even among the non-Muslims.[26] However, the restriction was relaxed in the later centuries. It has been reported that in Muslim lands in the Middle East, the Jews and the Armenians were involved in banking business (Kurat, 1976, p. 182). Obviously they did not lend money without interest. Dudley North (1641-1691) who spent more than twenty years in Istanbul during the second half of the seventeenth century, operated a money lending business that offered funds to Turkish officials at a rate of interest sometimes ranging from 20 to 30 percent (Letwin, 1963, p. 186). In Egypt the indigenous banking and finance had been in the hands of minorities especially Jews. Their locality in Cairo, Ḥārrat al-Yahūd, was infamous for usurious lending and exploitation (Mubarak, 1882, Ch. 103). In medieval India ruled by Muslim kings, since land revenue was largely collected in money, and due to unavailability of interest-free loans, demand for credit increased, leading to lending with interest. But this business was mostly carried out by Hindus (Spengler, 1971, 120).

3.2 Nineteenth Century Muslim scholars reject banking based on interest

The nineteenth century marked the beginning of intellectual, economic and Islamic awakening of Muslims.[27] They learned about Western banking during this period. In the earlier centuries, their contact with the West was almost one-sided. After Napoleon's occupation of Egypt during 1798-1801, the Arabs realized that it was Europe's superiority of scientific knowledge that helped the invention of advanced military arms and ammunition, which was lacking among Muslims. This realization encouraged the Egyptian ruler Muhammad Ali (d. 1849) to send scholars to Europe to study its sciences. This initiative gave an opportunity for Arabs to mix and interact with Europeans. Among the first deputation sent to Europe was headed by Rifa'ah al-Tahtawi (1801-73). When he visited Paris in 1824, there were no modern banks in Egypt.[28] Hence, the existence of banks in France attracted the attention of al-Tahtawi. He observed with great surprise: "… the greater businesses are those of tradings, and the most famous of them is the banking business. … People can deposit with the bank whatever they want to deposit, and take the legally fixed profit which is not considered by them as *riba* (usury) unless it exceeds the limit fixed by the law" (Takhlis, p.149).[29] However, he did not approve their practice of interest. He remarked: "Had their earning not been mixed with interest (*riba)*, they would have been the best people from an earning point of view" (ibid.152).

Al-Tahtawi realized that *'al-salam'* (advanced sale at deferred date with immediate payment) could be used for financing needs of farmers and manufacturers. He called the rich Egyptian people and capital owners to establish companies based on *al-salam*[30] to facilitate economic transaction and abolish *riba* and relieve the needy from borrowing on interest. Even the bankrupt traders could be helped through this practice (al-Tahtawi, al-Murshid al-Amin, Chapter 1, Section 1). He also suggested establishment of banks to finance such projects and called it *Jama'iat al-Iqtiradat al-Umumiyah* (Common Borrowing Society) (Imarah, 1973, p. 185 quoted Manahij, Conclusion, 4th section). However, he did not explain its modus operandi. Such a deliberate curtailment shows the intent of Muslim thinkers of the nineteenth century to develop their own financial system based on Islamic ethos.

Bayram al-Khāmis (d. 1889), a Tunisian scholar of 19th century writes in his journey account of Italy: "If individual and group financing is not enough, they (Italian people) borrow money from banks. Individual or groups who have savings but cannot engage personally in investment activities, deposit them in banks and receive *riba* (interest) which is generally 6 percent per annum. People can deposit and withdraw at will whenever they want to do so. Banks pay 6 percent interest to the depositors and charge 10 percent from the borrowers, and the difference is their gain" (al-Khamis, 1884, 3:48). This shows his understanding of modern banking. His use of the word *'riba'* for the extra money which the banks offer on deposits or charge on borrowing indicates that he does not think it is permissible for Muslims. He did not use the word ribh (profit) or *fa'idah* (the term used for interest in modern Arabic).

It appears that to some of the nineteenth century Muslim scholars, the Western banking system was less exploitative as compared to local usurers.[31] However, the majority of them expressed their objection to the practice of interest by Western banks. Thus, it is not correct when Saba Yared (1979, p. 98) claims (about the 19th century Arab scholars) that: "They did not relate interest earned in these institution with the prohibited riba". It is reported that when Barclays Bank was established in Cairo during the late 19th century, Islamic scholars criticized and opposed the element of interest practiced by the bank (Askari et al. 2012, p.59; Ackgunduz, 2009, pp. 39-40). Ironically, Mufti Muhammad Abduh's (1849-1905) student and friend Rashid Rida (1865-1935) reports that the former allowed the interest offered by the post office on investment deposit. However, no such statement of Abduh is traceable. Even Rida's report is ambiguous.[32]

Dr. Hamidullah gives us the earliest record of an interest-free lending society in the last decade of the nineteenth century. In 1891 Sayyid `Umar Qadiri, a religious and mystic dignitary of Hyderabad-Deccan conceived the idea of interest-free loans on a co-operative basis, and put it to practice. Its name was *Mu'aiyidul-Ikhwan* Society.[33] (Hamidullah, n.d., p. 493). The following was its modus operandi:

> The Secretary and his friends and numerous disciples contributed towards its capital by handing over to the society the hides of animals sacrificed during *Baqrid* festival[34] as also other charitable endowments. They also deposited their monies for safe custody, for fixed periods or as current accounts. With such meagre resources in the beginning, the society has developed into a flourishing institution in the metropolis of the Nizam[35]. The founder-secretary was succeeded by his learned son Maulana Syed Muhammad Badshah Husaini, under whom the society has lent during the past few years about half a million rupees, based on the security of valuables such as ornaments of precious metals and the like, without charging any interest, and collecting back the amount in easy installments. (Ibid).

The society was in existence till the middle of the twentieth century. While it was functioning, it set an example to a number of new interest-free lending societies which were established in the early twentieth century.[36]

4.0 Reason for the Absence of Formal Islamic Banks Prior to the 20th Century

Development of the modern bank in the West was readily seen during the 13th – 15th centuries (Homoud 1986, 10). Following this period of growth, in 1609 CE the Dutch Amsterdam Bank was established and became the role model of other new European banks subsequently. During this period Muslim culture and economy entered into a phase of decline or remained stagnant. Thus no attempt was made to develop the economy and finance to match the European economies. This does not mean that lending–borrowing and financing activities ceased. Their economies were mired in little growth as depicted by al-Jarhi (2006, p. 13): "It is an undeniable fact that Islamic financial institutions have had only a marginal existence during the last 300 years. They did not get the same chance as western financial institutions to gradually evolve their institutional structure, tools and modus operandi to their full potential".

Timur Kuran wrongly assigns prohibition of interest in Islam as the reason for non- emergence of a banking system in the medieval period.[37] He asserts: "The ban on interest also meant that banks could not emerge" (Kuran, 2011, P. 7). The fact is that when organized banks started in Europe during the 15th and 16th centuries, the Islamic world was already experiencing a decline in economic and intellectual spheres.[38]

At about the same time, the decaying phase of Islamic history began; Mufti Taqi Usmani says: "… during the past few centuries the political decline of the Muslims stopped this process (of *ijtihad* and *istinbat*) to a considerable extent" (Usmani 1998, p.163). Mercantilism, which was in full swing in Europe, could not grow in the Muslim world.[39] A number of factors boosted Western economies, and directly or indirectly helped them establish corporations, maritime trading companies and banks. For example, scientific discoveries, use of machines, rapid increase in production, availability of surplus product for trading purpose, discovery of a new world that provided new markets, establishment of colonies as a source of raw material and ready market for finished products, and a newly discovered all water route of European trade through the Cape of the Good Hope. The Muslim world was completely absent from all these happenings.

The discouraged merchants and declining mercantile activities eschewed demand for credit. In other words, ‘lending’ or financing on the basis of partnership was open. Thus, the failure of development of banks in the Muslim world cannot be separated from an overall development such as business incorporations, and other commercial institutions.

During the nineteenth and twentieth centuries, the increasing contact between the West and the Arabs and the rest of the Muslim states made the latter realize the awful gap between the West and the East in the sphere of education, science and technology, politics and economics, and attention was drawn to rectify the situation. Freedom from colonial rule gave the Muslim states self-reliance and confidence. They established scientific and educational institutions of higher grades, renewed their thinking on economic problems, established research and training centers, revived *ijtihād* and creative thinking. Their attention was drawn to promote agriculture and industries, establish investment companies, and organize interest-free lending societies and financial institutions. However, they failed to innovate interest free banking till the 1960s.

5.0 Twentieth Century Developments

As we noted above, by the end of the nineteenth century Muslims of Hyderabad had an interest-free credit society which continued to flourish till the fall of the Hyderabad State in the middle of the twentieth century. Hamidullah has also given an account of many other similar societies which were established in Hyderabad in early twentieth century, right up to the 1940s (Hamidullah, n.d., pp. 493). Following is a list of some of the major societies that worked for interest-free monetary transactions:

1. *Mu’aiyidul-Ikhwan* (Supporter of the Brothers) Society (established in 1891 in Hyderabad)
2. *Mu’inul-Ikhwan* (Helper of the Brothers) Society (established sometime before 1902 in Hyderabad)
3. *Mu’inul-Muslimin* (Helper of Muslims) Society (established in 1902 in Hyderabad)
4. Interest-free Lending Society established with the Co-operative Department[40] (1917) in Hyderabad

Bagsiraj notes two major interest- free cooperative societies in the pre-partition Indian subcontinent:[41]

1. The Patni Co-operative Credit Society Ltd. established in 1938 in Gujarat, and
2. The first Muslim Fund established in 1941 at Tada Bavli in Uttar Pradesh, a state of India.

The Muslim population's great desire to avoid interest can be learned from the fact that Islamic financial Societies in India grew from just one in 1941 to one hundred forty four in 1998 (Bagsiraj, 2003, p. 11).

As far as the Arab world is concerned, we do not have much details but it has been reported that in the early 20th century, they started thinking - about establishing Islamic banking. A very preliminary suggestion was given by Hafni Nasif in his lecture delivered in 1908 at *Dar al-Ulum*, Cairo. He said:

> "One who wants to establish an Islamic bank (masraf Islami),[42] should print samples of 'örnik' meant for loans and another sample for Shariah subterfuge so that there would be no mention of any benefit. This is very easy".[43] (al-Masri, 1999, pp. 179-80)

5.1 Preparation of academic and theoretical ground for establishment of modern Islamic banks

Prohibition of interest is the raison d'être of Islamic banking. Mawdudi started writing against interest from the 1930s, although his work on interest appeared in a book form only in 1961. The first exclusive work related to Islam and the theory of interest was authored by Anwar Iqbal Qureshi, a professor of Osmania University during the 1940s.

According to Hamidullah, abolition of riba is not enough. To make it successful, there should be provision of interest-free financing. He argues for the state arrangement of interest free loan at national level as well as international level. "It goes without saying that a government alone is the best qualified in an organized society – and not private individuals – to forego interest on loans advanced to anybody." Provision of interest free loans is the requirement of Qur'anic teaching, and it was performed by the government in the past. "There is no reason" he stressed "why this institution should not revive and adapt itself to modern needs" (Hamidullah, 1955, p. 11).

It may be noted that from the experience of interest-free lending societies, Muslims did not enter directly into the practice and foundation of interest-free banking. The scholars first critically examined the Western banking system, discussed and analyzed its functioning and finally made proposals regarding how to run a banking system without interest. In this way they prepared sound academic and theoretical grounds before founding Islamic banks.

It was during the 1940s that for the first time Muslim scholars thought that the mudarabah partnership could be used to replace interest to organize banking. The pioneers who conceived this idea include Anwar Iqbal Qureshi (1945), Shaikh Mahmud Ahmad (1947), and Naiem Siddiqi (1948).

Seoharwi (1969, p. 297) clearly stated that there is no place for interest based banking in an Islamic economic system. He was in favor of interest-free cooperative societies (ibid. pp. 299, 300-01). He considered interest-based banking as a source of capitalistic exploitation. He recommended replacement of banks by companies based on cooperation and *mudarabah* (ibid. pp. 296-301). In the first two editions of his book which appeared in 1939 and 1942 respectively, Seoharwi did not consider the topic of banking. But in its third edition, he criticized the Western banking system and advocated its replacement by Islamic cooperative institutions.[44]

Shaikh Mahmud Ahmad in his book "Economics of Islam" (1952 [1947]) envisaged the establishment of Islamic banks on the basis of a joint stock company with limited liability. Later he developed a scheme where banks provide free credit and debtors are required to furnish a counter loan. For example: if a person needs loan for any purpose from a bank for a certain period of time, then he should also give a loan to that bank in an amount such that the "values" of the two loans becomes equal (Ahmad, 1989). This model is known as "time multiple counter loan" or TMCL.

Although the *mudarabah* method or participatory financing had already been mentioned by many authors as an alternative to interest-based banking, it was Muhammad Uzair who provided a clear conception of Islamic banking based on *mudarabah*. His brief treatise An Outline of Interest-less Banking was published in 1955 simultaneously in Karachi and Dacca. The Egyptian scholar Muhammad Abdullah al-Arabi elaborated on the idea of Islamic banking in a paper published in 1966. Later on Siddiqi elaborated on the mechanism of *mudarabah* in his work *Ghayr sudi bankkari* (Banking without Interest) and its companion volume *Shirkat-o-mudarabat ke shar'i usul* (Partnership and profit-sharing in Islamic Law) in the late 1960s, popularly known as two-tier *mudarabah*. Both works were in Urdu but later they were translated into English.

According to Siddiqi, Baqir al-Sadr in his work *al-Bank al-la-ribawi fi'l-Islam* took a different position:[45] "The banks shall also accept deposits in current accounts with the promise to pay on demand. No profits are to be paid to such depositors from whom a service charge may or may not be collected. The bank shall be obliged to grant short-term interest-free loans on a limited scale" (Siddiqi, 1981a, p. 32).

In his short article "A Suggestion for an Interest-Free Islamic Monetary Fund", Hamidullah argued for the establishment of an Interest-Free Islamic Monetary Fund along the lines of the International Monetary Fund (IMF). As early as 1955, he advocated for the establishment of an Interest-Free Islamic International Monetary Fund, modeled on the IMF. In his opinion, this will "loosen the foreign grip on the economic independence of the Muslim States" and save them from their machination" (Hamidullah, 1955, p. 12). Dr. Hamidullah's dream was fulfilled to some extent by the establishment of the Islamic Development Bank (IDB) in 1975 with its headquarters at Jeddah as well as other private banks in various Muslim countries during this period and in the subsequent years.

5.2 The Era of Modern Islamic Banks

Before we conclude this paper, it is worthwhile to give a brief account of the early efforts of establishing contemporary Islamic banks. The sixties of the last century saw the beginning of the experiment of banking in tandem with those in the West. In 1963, Ahmad al- Najjar[46] established the first Islamic bank in Egypt called Mit Ghamr Saving House, named after the town Mit Ghamr where it was located. It was surrounded by rural areas and it mainly served the rural population. It functioned on the basis of profit and loss sharing concept.

The Mit Ghamr Saving House was a successful experience. But it was eventually liquidated for political reasons (Kahf, 2004, p.19). Nevertheless, it had shown the way how commercial banking could be organized on a non-interest basis. The experiment lasted until 1967, by which time there were nine such banks in the country.

Another experiment in Islamic banking and finance that can be found during that period was the Tabung Haji in Malaysia. It was set up for Muslims to save for their expenses for pilgrimage to Makkah using interest-free deposit and investment. Tabung Haji Malaysia also provided services to those interested in going on a pilgrimage to Makkah.

In actual fact, Tabung Haji was planned in August 1962 and launched on Sept. 30,1963. But it remained unnoticed until royal professor Engku Abdul Aziz of the University of Malaya, a reputed academician and an authority on rural economy, presented the idea of setting up the Pilgrims Saving Corporation with a view to assist Muslims to perform the pilgrimage to Makkah without impoverishing them and sparing them from financial hardship on their return. Thus the Corporation was established to provide facilities for Muslims to both save and invest profitably. While the Mit Ghamr Saving House faced hostile political atmosphere and was closed down in 1967, Tabung Haji enjoyed favorable political environment and is still flourishing. The closure of Mit Ghamr Saving House may have brought pressure on the government to fill the vacuum. Hence the Egyptian government established the Nasir Social Bank in 1971 and declared it as an interest-free commercial bank (Kahf 2004, p. 19).

In 1973, another Islamic bank, Philippine Amanah Bank, was established in the region which has survived till today, though with a new name. An individual's effort, that is, of Irshad Ahmad's, in establishing Islamic banking which can be seen in Karachi has generally remained unnoticed by writers on modern history of Islamic banking (Siddiqi, 2015, p. 147). Dubai Islamic Bank was among the first modern Islamic bank which was established in 1975 on a private initiative.

A significant milestone in the history of Islamic banking was the establishment of the Islamic Development Bank (IDB) in 1975 which was set up to act as an international financial institution after the Declaration of Intent issued by a Conference of Finance Ministers of Muslim Countries held in Jeddah in December 1973. More Islamic banks were created in that era especially in the Gulf including Kuwait Finance House in 1977 and Bahrain Islamic Bank in 1979. During the 1980s, Pakistan, Sudan and Iran declared Islamization of their banking system and subsequently the practice spread worldwide – new banks were established and many conventional banks opened windows for acceptance of interest-free deposits.

6.0 Concluding remarks

Currently Islamic banking and finance is the most practiced aspect of Islamic economics. But the writers on the subject have different opinions about the commencement of interest-free lending societies and the dates of the establishment of Islamic financial institutions. The earliest they venture to is the forties of the last century. In fact, surplus and deficit units existed in all societies in all ages. And the history of the essential functions of banks - lending and borrowing- can be traced to thousands of years before the advent of organized banks.

Commencement of interest-free lending societies and the dates of the establishment of Islamic financial institutions. The earliest they venture to is the forties of the last century. In fact, surplus and deficit units existed in all societies in all ages. And the history of the essential functions of banks - lending and borrowing- can be traced to thousands of years before the advent of organized banksemergence of modern Islamic banks, presented in the preceding pages, are enough to refute the allegation that Islamic economics and banking was developed 'for reasons of identity protection'. In fact it was an attempt to practice economic life in the Islamic way. Muslims felt religiously obligated to shun interest.

It is also not true that Islamic banking was promoted by the petrodollar and oil boom of 1970s. The first modern Islamic bank was established in a small town of Egypt called Mit Ghamr with an agricultural economy. It was not in an oil rich country. Earlier in Pakistan in the late 1950s rural landlords created an interest-free credit network (Wilson, 1983, p. 75). Similarly Tabung Haji, the forerunner of Islamic banks in the South East Asia, was established to fulfill the desire of Malaysian Muslims to spend money on their pilgrimage clean and devoid of interest. Muslims, especially those in the rural areas who were concerned by the immorality of bank interest, used to save and arrange huge amounts for their pilgrimage through traditional methods. In many cases they sold their lands and other assets to meet the expenses of their hajj journey. Tabung Haji was established to help them. These events took place much earlier than the oil boom. These facts are enough to refute those who say that the development of Islamic banking and finance was the result of pan-Islamic movement or it was an outcome of oil discovery in the Middle East (Warde 2010, 93; El-Gamal 2006, 137). There is no doubt that the prosperity in the Middle East has helped Islamic banking and finance as it helped the economy of the region in general. But it is very obvious that the oil boom benefited interest based Western banks much more than the newly established Islamic banks which constituted a very tiny part of the whole banking system. Indeed, it would be interesting to conduct a comparative empirical study of the impact of oil boom on both types of banks – interest based conventional banks and the interest free Islamic banks.

Endnotes

1 This is accepted even by adversaries of the discipline. See for example Kuran (2004, x).

2 Ibrahim Warde shows his lack of awareness of the history of Islamic banking and finance when he says: ‘Modern Islamic banking would probably not exist were it not for two political- economic developments: pan-Islamism and the increase in oil prices’ (Warde, 2010,p.93.). El-Gamal (2006, 137) repeats the same notion.

3 Khadijah bint Khuwaylid (c. 555 or 567 – 620 CE) was a pious, wealthy lady of Makkah. Being very impressed by the diligence and honesty of Prophet Muhammad, she later married him, thus becoming his first wife and the “Mother of the Believers”.

4 Abu Sufyan Sakhr ibn Harb (560 - 650) was the leader of the Quraish tribe of Makkah. He was a staunch opponent of Prophet Muhammad before accepting Islam and becoming a Muslim warrior later in life.

5 For details of various modes of business in the early period of Islam, one may refer to Sa’id, Humam Abd al-Rahim and Muhammad H. Mulhim (2016), Mawsuah Ahadith Ahkam al-Mua’amalat al-Maliyah, Riyadh, al-Bayan, especially pp. 109, 116-20, 131, 615, 620-23, 698-701, 738-59 and 771-79.

6 Al-‘Abbas ibn ‘Abd al-Muttalib (c. 567 – c. 653 CE), a wealthy merchant during the early years of Islam, was a paternal uncle (just three years older than his nephew) and sahabi (companion) of Muhammad.

7 Al-'Abbas ibn 'Abd al-Muttalib (c. 567 – c. 653 CE), a wealthy merchant during the early years of Islam, was a paternal uncle (just three years older than his nephew) and sahabi (companion) of Muhammad.

8 Uthman ibn Affan (576 – 656) was a rich companion of Prophet Muhammad (pbuh) and the third of the "Rightly Guided Caliphs".

9 On another occasion, Dr. Hamidullah reiterates, "As the indebted ones form an independent category, quite apart and distinct from the poor and the indigent, it is obvious that the "indebted" can refer here only to the well-to-do people, who temporarily require urgent monetary help." (Hamidullah, 1936, 10/2, p. 213).

10 Hind bint 'Utbah (who lived in the late 6th and early 7th centuries CE) was the wife of Abu Sufyan ibn Harb. She was the mother of Muawiyah, the founder of the Umayyad dynasty.

11 *Qirad* or *muqaradah* is an alternative term for *mudarabah*

12 Umar ibn Abd al-Aziz (682-720 CE) was an Umayyad caliph who ruled from 717 to 720. He was also a cousin of the former caliph, being the son of Abd al-Malik's younger brother, Abd al-Aziz.

13 The word *sukuk* is plural of *sakk*. Here it has been used in the sense of documents issued by the ruler for a person stating the quantity of rations that person is entitled to receive.

14 al-Zubayr ibn al-Awwam (594–656) was a companion of Prophet Muhammad and a commander in his caliph's army.

15 It may be pointed out that in Islamic law there is fundamental difference between *amanah* and *qard*. In case of *amanah*, the *amin* (person entrusted) has to keep it safe and protected. He has no right to use itnor shall he be liable to return it if it is lost despite all his care. In the case of *qard* (loan), the loan seeker has full right to use the amount and is liable to return the amount in any case.

16 It may be noted that IRTI/IDB has prepared a 3-volume project titled *Mashru al-Muntajat wa'l-Adawat al-Maliyah fi Fiqh al-Mali* (Financial Products and Instruments in Financial Jurisprudence Project) which contains more than a thousand types of contracts that were used in early centuries of Islam centuries (IRTI/IDB 2009).

17 For details see *abwab al-sarf* or chapters on exchange in any *fiqh* book.

18 Even at present, these financing methods are used by Islamic banks. Their details can be seen in any work on Islamic jurisprudence and in most of the works on Islamic banking and finance.

19 *Suftajah* was used to facilitate trading activities. Basically a debt transfer transaction, it has been practiced in Islamic societies since the `Abbasi period.

In *suftajah* a debtor, A, authorizes B, his agent (*wakil*) or someone who owes him a debt, to pay a given amount to C to whom A owes a debt. It was also used to transfer funds by merchants. http://www.al-baraka.com/glo.php?cat=s

20 Cash waqf is defined as ‘trust fund established with money to support services to mankind in the name of Allah. The capital was “transferred” to borrowers for a certain period, which was then spent for all sorts of pious and social purposes inclusive of meaningful investments.

21 *Bay al-wafa* means ‘sale of fulfilling promise’. It is so called because the buyer fulfills his promise to return the sold object when the seller returns the price. See Islahi 2015a, pp. 29, 35.

22 Sale on buyback expectation (Ibid. 2015a, pp. 28-32).

23 *Bayʿ al-ʿinah* is a controversial transaction in which, for example, A sells an article to B on credit for sum X+*i* which B will pay at future date; at the same time A buys back the article from B for the sum X which he pays to B in cash; the purpose of the difference, *i* in the two sums, is obvious – interest (IbnTaymiyah. Vol. 29, pp. 30, 432, 439). This practice was prevalent also in medieval Europe under the name of *muhatra* (Schacht, 1936, vol. 3, p. 1148, Grice-Hutchinson, 1978, p. 48, 48, 59n). If a third party is also involved in this transaction, it is called *tawarruq*. Taqi al-Din al-Subki, a contemporary of IbnTaymiyah has dealt with this issue in his *fatawa* in more detail. In Egypt the word *al- muʿamalah* was more common for that kind of business (al-Subki, n.d., vol. 1, p. 327).

24 A tripartite sale arrangement to obtain cash.

25 Europe of the sixteenth century innovated use of partnership to trade for a comprehensive corporation and joint-stock companies which attracted large number of shareholders, in a marked contrast to the earlier forms of commercial organization, which seldom comprised more than three or four partners (Flinn, 1965, p.62).

26 al-Sajistani, n.d. vol. 3, p. 132, Chapter 30, *hadith* no. 3043.

27 For details see Islahi, 2015b, pp. 9-11

28 The first bank was established in 1855.

29 It should be noticed that he used the word ‘*riba*’ for the bank interest, not the word ‘*faidah*’.

30 It may be noted that *salam* is one of the products of Islamic banks available at present for investment. Under this provision, in early Islamic system the agriculturists were provided finance before the cultivation or harvest to fulfill their financial needs and they could repay in kind when the crop was ready.

31 Sometimes the local usurers charged about 100 percent per month while

the bank charged 10 percent per month (Islahi, 2015a, 62).

32 For further details regarding Abduh's statement and its analysis, see Islahi (2015a, pp. 75-76; Homoud, 1986 [1985] pp. 111-12, 280 note no. 332); Badawi, 1964, pp. 223-39).

33 Society for the help of brothers.

34 Festival of animal sacrifice, *Id al-Adha*.

35 "Nizam" was the title of the rulers of Hyderabad State since 1724.

36 See Dr Hamidullah's article "Haidarabad's contribution to Islamic economic thought and practice" in Islahi's (2015c) collection of papers entitled *Muhammad Hamidullah and His Pioneering Works on Islamic Economics*, pp. 156-58.

37 Twentieth century developments in the Muslim world prove the inaccuracy of Kuran's thesis.Now there are big Islamic banks wherein the interest is prohibited.

38 In the declining phase of intellectual exercises, the dominating features were imitation, repetition, reproduction, writing commentary, commentary-over-commentary, emphasis on traditional education, etc. The printing press was introduced to the Middle East only after two centuries of its invention in Europe. When the West was establishing universities in Europe, the East could not even maintain advanced education of Islamic sciences, not to mention scientific education.

39 For a detailed discussion on the topic, see Islahi (2009b).

40 Regarding this, Hamidullah notes: Soon the Government in Hyderabad also took notice, and established a Department of Co-operative Societies in 1913, and it took four years to persuade the officials concerned, suffering as they were from inferiority complex, to consent even to register interest-free co-operative lending societies, under the Co-operative Societies Act. Mr. A. M. Khalilullah, the father of the present writer, an Assistant Revenue Secretary was the pioneer and champion of the cause for about thirty years until his death, and a society established by him in the Revenue Secretariat was registered with the Co-operative Department as the first Interest-free Lending Society on a new model. Others followed suit, and there are now scores of such societies all over Hyderabad for Government Departments as well as enterprises, for general public, for instance for specific streets, factories, families and the like. (Hamidullah, n.d. p.493)

41 For details see Bagsiraj (2003).

42 Perhaps this may be the earliest and the first time the term "*masraf Islami*" (Islamic banking) was used.

43 Quoted by al-Masri in *al-Jami' fi usul al-riba*, 1999, Damascus: Dar al-

Qalam, pp. 179-180. The statement is not very clear and precise. No explanation has been given by Hafni. According to al-Masri, it means that basically the transaction should be without interest but simultaneously there would be an underlying contract, such as sale, which entails interest in a hidden way (ibid. p. 180).

44 Siddiqi (1981a, 30) in his survey of literature on Islamic economics observes that there is nothing in Seoharwi's book on Islamic banking. Perhaps he had referred to the second edition. In the third edition of his book which appeared in 1946, Seoharwi touched on the topic of banking. It may be noted that in 1945 Qureshi published his book *Islam aur Sud* (Islam and interest) and Seoharwi seems to be influenced by Qureshi's book as he refers to Qureshi at several places (pp. 273, 278, 298).

45 Baqir al-Sadr's work *al-Bank al-la-ribawi fi'l-Islam* appeared in late 1960s as a response to a questionnaire by a group of people in Kuwait who wanted to establish an interest-free bank. For a detailed comment on his work and works of other writers from the same period, refer to Siddiqi (1981a, pp. 30-37).

46 Al-Najjar the founder of Mit Ghamr Saving House, was a nephew of Muhammad Abdullah al-Arabi, one of the pioneers of Islamic economics and interest-free banking. No doubt, al-Najjar was inspired by the German model of interest-free banking and he presented it also as a German experience but as he himself noted in his work *Harkat al-Bunuk al-Islamiyah* (1993, p. 32), "He started it in disguise of a saving bank using the name of an European government so that his step might succeed amid the interest based banks as it was a time when opposition to Islamic trend was at the peak, without making explicit its Islamic nature, something which was exposed anyway. It was a great success, and its success revealed its Islamic identity. We had no other way. The result was that it was targeted with all might and its founder was forced to leave the country to merge it with other interest-based banks to lose its identity". To conceal the Islamic identity of the bank, even the *zakah* fund was named as the 'social service account'.

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