

Banking And Islamic Law



Dr. M. Muslehuddin

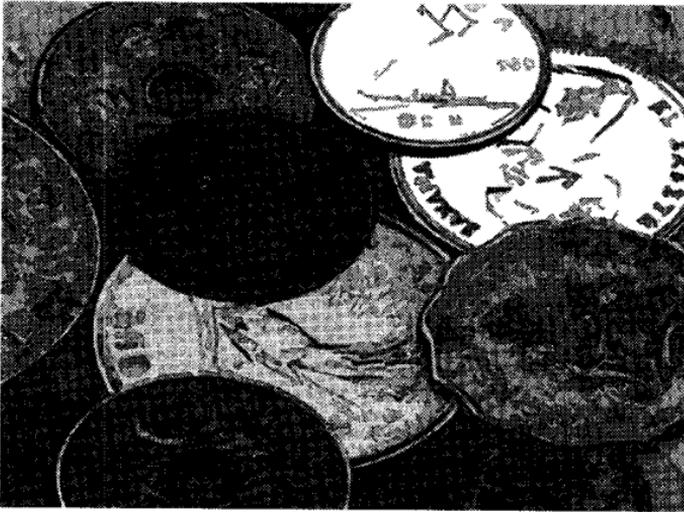
Modern economic system, all over the world, rests on Banks which functions primarily on interest. Thus if Banks can be made to function without the elements of interest, it would mean that an economic system can also be developed without the infusion of interest which is strictly forbidden in Islam. Dr. M. Muslehuddin, an economist of repute, convincingly argues that interest-free banking conforming to Islamic Tenets is possible. Coupled with an enlightening resume of the evolution of banking system and how this system, in different advanced countries, is an indispensable work for all those interested in Islamic Economics.

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FORWARD

Modern economy with its high technological advancement, growth of industrial and commercial organizations, and mounting expenditure in public sector by almost all Governments, has become so enormous that it requires special financial agencies for its running. That is why present banking is not only expanding rapidly but is also becoming more and more specialised and sophisticated. This is as true of Muslim countries as of others, but it poses one difficulty for the former. Interest has become an integral element of banking, but it is prohibited in Islam, and the problem is how we can derive benefits of this system till we get rid of interest.

Obviously the Muslim countries cannot just do away with banking on account of the element of interest, because of the vital role which banking plays in development. So the Muslim countries face a dilemma: Whether to keep the banking system and thus keep alive the institution of interest also or to dispense with it entirely in order to get rid of interest. Or is there any other solution?

The problem, though complicated, calls for a solution. If modern banking operations and their ramifications are critically examined, it will be found that interest actually plays rather a sinister role and, so far as the larger interests

of humanity are concerned, it vitiates the benefits which expansion of economy and development are expected to confer. And, for the matter of that, it hampers economic progress and economic justice for mankind.

A number of writers have given thought to this grave problem, and suggested measures for interest-free banking. But the literature on the subject is still rather scanty, and the details remain very much to be thrashed out for a change-over. The matter requires the attention of those experienced and serious bankers who have the interest of humanity at heart and who could make practical suggestions for carrying out the necessary reform.

Although not a practical banker, Dr. Muslehuddin, too, has tried his hand at this issue, and after giving a readable account of banking, has presented his views on the subject in a useful and objective way as to its operations in the light of Islamic law. In the hope that his book will be a valuable addition to the literature and material for thought on interest free banking, we present it to the public in general and to students of economics and law in particular.

The Islamic Research Academy is grateful to Dr. Muslehuddin for giving it the opportunity of publishing this work.

S. Munawwar Hasan

INTRODUCTION

Whether banking is possible under Islamic law is the problem we are confronted with. There are some who hold that no banking is possible without interest, for interest is the basis of banking, while others maintain that interest is avoidable and banks may be established free of interest. Clearly, interest is the crux of the problem. Then what is interest? Interest or *Riba*, according to Islamic law, is an excess over the principal and as such covers the modern interest in all its forms. It is a monetary advantage without a countervalue and, therefore, declared unlawful by the clear text of the Qur'an. In view of its destructive nature the Prophet has taken care to strike at its root by adopting preventive measures against all such possibilities as may lead to it. So the Jurists draw a mark of distinction between what is purposely and expressly forbidden and that which is prohibited by way of preventive measures. This we have discussed in Chapter 16.

Those who are of the opinion that interest-free banks may be established, suggest that banking in Islam should

have *Mudaraba* or partnership as its basis. But *Mudaraba*, as has been dealt with in Chapter 14, is of a limited scope and risky for banking. The question is: what is the alternative? The answer lies in the quality of our requirements, because the banking system is always geared to the economic needs of society. In evolving a banking system of our own, we have therefore to take into consideration our economic needs and the present condition of society, on the one hand and Islam and its laws on the other. For this purpose we have to find out what original avenues Islam can open in this regard, and what methods will be used to promote banking in Islam. For it can not be denied that economic needs of Islamic society have grown in bulk and that we have to keep pace with the march of times or we perish. See the pressing need for loans and that too on interest. Muslim states, though politically independent, are yet economically dependent as they need interest carrying loans of the World Bank and of other nations for their development, nay, for their very subsistence and survival. These are the hard facts and bare realities that we have to face.

Under the circumstances it will be of no avail if one takes shelter under fallacious solutions or is beguiled by plausible arguments, for that would be a charming delusion and nothing more. We are therefore required to take stock of the situation and try to know what precisely our

requirements are and how to meet them under Islamic law. It should first be admitted that we have lagged behind and our key problem is economic development to which the banks contribute largely. Secondly we have to look for those guiding factors which can help us to orientate a system of banks without violating the fundamentals of Islam.

A careful study of Islamic law and its application to modern requirements is, therefore, of vital importance. Islam is a universal religion and for all times to come. Its laws are based upon broad principles that admit of interpretation to cover all the aspects of life and if there be anything essential uncovered, recourse may be had to the Rule of Necessity and Need which has been explained in Chapter 13.

It is in this light that we studied the Islamic Law and have put forward a workable solution in the hope that it may lead us to success.

The work is a result of comparative study and for the purpose of better understanding we have divided it into two parts. One, deals with banking, its origin, history and functions, the other with the principles of Islamic Law and their application to banking. It has to be pointed out, here, that commercial banks, the creatures of modern age, have

been the subject of our study as they have combined in themselves the important features of almost all other banks and it is well said, that the theory of banking has to do primarily with the functions of commercial banks. Further a reference is made of the relations between Commercial and Central banks while the purpose and procedure of the world Bank and its affiliates have also been explained, so that a complete picture of banking system may be presented to the view.

There is also a bibliography of the books that have been consulted in writing this work. The citations from the Qur'an are mainly based on the translations of Marmaduke Pickthal (Hyderabad Deccan, 1938. A. D.) and Abdullah Yousuf Ali (Lahore. 1938).

PART I

**BANKING
IN
GENERAL**

BANKING AND ISLAMIC LAW

CHAPTER 1

ORIGIN AND NATURE OF BANKING

THE DEFINITION

The word bank is said to have been derived from the Italian word *banco*¹ the original meaning of which is 'shelf', 'bench'. It was extended to that of counter' money-changer's table upon which medieval European moneylenders and money-changers used to display their coins, whence 'bank.'² The above version seems to be correct, for money changing, in ancient banking was looked upon as the most important function of a banker. The *banco* or bench of a medieval banker was broken by the people if he failed in his business and this probably is the origin of the word 'bankrupt'.³

None of the statutory definitions of a bank is completely general. The New York state banking Law defines a bank as any domestic moneyed corporation, other than a trust company, authorised to discount and negotiate promissory notes, drafts, bills of exchange and other evidences of debt; to receive deposits of money and commercial paper; to lend

money on real or personal security, and to buy and sell gold and silver bullion, foreign coins or bills of exchange'. The term 'banker' defined in the Bills of Exchange Act. 1882. and the Stamp Act. 1891. is any person carrying on the business of banking, is not of any value and does not carry us very far.⁴

THE FUNCTIONS

Modern banks perform a variety of functions, some of which are given below:-

1. Various kinds of money dealings, such as money changing, shipment of money or bullion, purchase and sale of bullion.
2. Receiving deposits.
3. Discounting (i.e. purchasing at present worth) commercial paper (i.e. bills of exchange and promissory notes).
4. Granting loans in other ways either by advances against securities or by way of overdraft, mortgage loans, or by the purchase of shares in industrial companies.
5. Issue of bank notes — this function is now a days virtually restricted to the Central Bank of issue. In the eighteenth century it was regarded as an essential function of all banks.

6. Dealing in foreign exchange.
7. Performing agency functions on behalf of clients. such as:
 - (a) Safe custody, sale or purchase of securities.
 - (b) Safe custody of other valuables.
 - (c) Collection of dividends and bills.
 - (d) Acting as correspondents and clearing agents for other banks.
 - (e) Issuing letters of credit.
 - (f) acting as trustees, executors, attorneys.
 - (g) Serving as bankers to joint stock companies.⁵

SPECIALIZATION

It must be remembered that all the above functions are not performed by every bank. There is division of labour and specialization. Commercial banks are formed to accept deposits for short periods and lend credit also for short periods (for the current finance of trade and industry) in England and in the U.S.A. In contradistinction to these are the Industrial or Investment Banks, like those of Japan, which make advances for long period to industrial concerns and raise their capital by debentures. But the Credit banks in Germany, are of the mixed type and combine ordinary commercial banking with investment banking. There are,

in addition, certain banks specialised in mortgage banking. Some in financing of foreign trade or foreign exchanges. All these banks may be called profit making concerns, while Central banks are of a special class acting as agents to their governments and generally empowered to issue paper currency.⁶

AMALGAMATION

The process of amalgamation between private and joint stock banks as well as between joint stock banks themselves has been a striking feature of modern banking. It is all under the stimulus of a desire to avoid competition and promote large scale production and in consequence five most powerful banking institutions or the 'Big Five' (Barclays, Lloyds, The Midland, National Provincial and Westminster banks) have come to the fore in England.

While this amalgamation is advantageous in bringing about efficient organization, expert management, centralization of resources, wider and cheaper banking facilities, it is attended by the evils of monopoly and becomes unwieldy, cumbersome and excessively centralized (if the process of amalgamation is carried too far), and leads to the neglect of local interests.⁷

BRANCH AND UNIT BANKING

Another striking feature of modern banking is the

development of branch and unit banking systems. They are, in fact, the two rival systems. Under the branch banking system, there is a small number of very large banks, each having numerous branches. This system has been popular in England, Canada, South Africa and France. The U.S.A. retains the same original system of unit banking i.e. a great many small independent banks. In the unit banking system the bankers' operations are confined in general to a single office, though some few are allowed to have branches within a strictly limited area. This sort of restriction is the outcome of the traditional fear of a 'Money Trust' Even the Central bank of the United States is a federation of twelve banks, each with its own region.

The branch banking is useful in this respect that it offers cheap and widespread facilities and enables funds to be transferred from one branch to another according to the needs of different places while its defect lies in this that it results in monopolistic control, excessive centralization of authority at head quarters and neglect of local interests. Unit banking possesses opposite merits and weaknesses. On the whole, branch banking is preferable as it minimizes the risk of failure.⁸

CLASSIFICATION OF BANKS

The most common classification of banks is according to the purpose they serve. In this respect banks are of many

kinds. Throughout the world we find commercial banks, saving banks, mortgage banks, investment banks, agricultural banks, cooperative banks and many others that perform special or general services. So far as their policy in making advances is concerned, most of them fall into two categories: (1) Commercial banks whose deposits are known as demand deposits, and therefore they prefer to have credit transactions of comparatively short term. (2) Investment banks whose deposits are known as time deposits and therefore they embark upon the policy of advancing long term loans. But it has to be admitted that Commercial banks have combined in them the features of investment banks in that their short term loans are at times, extended to become long term loans. And, therefore, it is remarked that the theory of banking deals largely with the operations of commercial bank.¹⁰

The above two categories do not include Central banks which are a class in themselves as they act as fiscal agents to their governments and are custodians of treasury funds, issue paper currency, carry the gold reserves, serve as a depository for other banks of last resort bear the responsibility of controlling the supply of credit.¹¹

BANKING SYSTEMS ALL OVER THE WORLD

Almost each country in the world has got a central bank to perform the functions, more or less, similar to those of

the bank of England which is a central bank itself. But the United States of America and the Union of Soviet Socialist Republics stand apart with distinct banking systems of their own. So we rest contented with giving, in some detail, the main features of the Bank of England, whose pattern is followed, with some changes, by most of the countries. Added to this are the short sketches of the banking systems in the United States and in U.S.S.R.

BANKING IN GREAT BRITAIN

Branch Banking is prevalent in England. This is in sharp contrast to the United States where due to fear of what is called a 'Money Trust' Units Banking is continued. The Bank of England was established in 1694,¹² and it is the only bank of issue in the country. The Bank Charter Act of 1844, divided it into two departments, namely, (1) the Issue Department and (2) the Banking Department which is concerned with normal commercial banking business of this Bank.¹³

The Bank of England is the banker of the Government, as well as the nation, and as such, has accounts of almost all the principal joint stock banks with it, where all surplus cash and other money of each of these banks is deposited. It occupies the position of the bankers' bank so far as the London Money Market is concerned though this Bank discounts bills for a few customers, it does not do so for the

general public. It has ten branches: The Western and Law Court Branches in London, and branches in Manchester, Birmingham, Liverpool, Bristol, Leeds, Newcastle, Hull and Plymouth. The Bank does not accept any new customers for ordinary banking business which is limited to a few old connections.¹⁴

It is in 1946, that the Bank of England become nationalised and its capital stock was brought into public ownership. The management of the bank is in the hands of Court of Directors composed of the Governor, the Deputy Governor and 16 Directors of the bank to be appointed by the monarch. The Governor and the Deputy Governor are to hold office for 5 years. The term of office of the Directors is four years. A person who has held office as Governor or Deputy Governor or Director, is however, eligible for reappointment.¹⁵

The Treasury has been given the right of giving directions from time to time to the Bank which they think, after consulting the Governor of the Bank, are necessary in the public interest. The Bank has also the right of requiring information from and can make recommendations to bankers and, with the authority of Treasury, can issue directions to any banker to secure that effect.¹⁶

In the United Kingdom, commercial banks do not usually borrow from the Bank of England to meet the

abnormal public demands for cash but they call in their advances to the money market. The discount houses and bill-brokers, who generally handle most of the demand and supply of bills of exchange can get cash from this Bank by rediscounting 'first class' eligible bills. Thus, on such occasions, the Bank of England can influence the discount market and through that the money market where short term loans are handled.

A new development, in the banking history of England, occurred in the middle of 1958. The system of special deposits was introduced to control the credit under which the Bank of England, if so required, may restrict the liquidity of The Banking system.¹⁷

BANKING IN THE UNITED STATES OF AMERICA

Unit banking system is the outstanding feature of banking in the United states. Another unique aspect of the banking system in U.S.A. is the compulsory insurance by the Federal Department Insurance Corporation of deposits upto \$10,000, which was instituted to preserve the unit banking system after the banking crisis of 1933. As a result of which 98% of all deposits are now insured.¹⁸ The rigidity of legislation and the strict control under which the commercial banks operate are other features not to be found in other countries. There are, again, twelve separate Federal Reserve Banks, as against a single central bank in Great Britain.¹⁹

The Central Banking Organisation in U.S.A. came into existence in 1913, with the passing of Federal Reserve Act. Consequently there are twelve Federal Reserve Banks and a coordinating body called the Federal Reserve Board with head quarters in Washington.²⁰ The vast area of the country has been divided into twelve districts, each having its own Federal Reserve Bank which acts, with in its area, as a banker's Bank. The Reserve Banks have the privilege of note issue against gold reserves, rediscount eligible paper brought to them by member banks and make advances against it the security of such paper and thus they act as the lenders of last resort.

In short, they perform the function for which the Central Bank exists, namely, to carry out the country's monetary policy with the instrument of the Bank Rate, Open Market operations and the Cash Ratio. Although the main function of the Federal Reserve Bank is to regulate the flow of credit and money, it performs other functions such as performances of essential services for the member banks of the Federal Reserve system, facilitating the clearance and collection of cheques, effecting telegraphic transfers of funds, acting as fiscal agents, custodians and depositories for the Treasury and other Government agencies.²¹

There are two types of commercial banks in the United States, National banks and state banks, the former obtain

charter from the Federal Government while the latter from a State Government. Not all banks are members of the Federal Reserve System, so they can be classified as member and non member banks. The credit policy of these banks is controlled by the Reserve banks but whereas in England there are only a few large banks with a nation wide network of branches, there were in the United States in January 1959, a total of 13,514 independent commercial banks, most of which unit banks with no branches at all.²² Both countries possess money market, but whereas the London money market forms the integral part of the British banking system, the New York money market occupies a much less important position. American member banks borrow from their central bank, whereas British commercial banks never do this directly, but instead call in some of their loans to the money market thereby compelling bill brokers and discount houses to borrow from the Bank of England. Unlike the Bank of England which does not compete against the commercial banks for ordinary banking business, the Federal Reserve Banks may, if they so desire, make loans directly to businessmen.²³ These are in brief the differences between central banking in Great Britain and that of the United States.

BANKING IN U.S.S.R. (UNION OF SOVIET SOCIALIST REPUBLICS) *

The whole banking system of this country is State

owned and is under the ministry of finance. The structure of this system consist of three groups namely (1) The State Bank (i.e Govts. bank)²⁴ which performs the function of a central bank such as note issue and acting as fiscal agent for the government (2) net work of savings banks and (3) four special banks for agriculture and industry.²⁵ But in 1959 the structure was streamlined into (1) The state bank, (2) The industrial bank and, (3) a new Investment bank.²⁶

The Gosbank is for all practical purposes the only commercial bank with a net work of correspondents abroad. Further, it has the exclusive right to deal in foreign exchange.²⁷ Its function is closely geared to the budget and the national plan. Since virtually all deposits come from enterprises controlled by the state plan, there is no need for Soviet banking officials to give some attention to liquidity as a western banker does.²⁸

Personal banking is carried on through the state Saving bank. It has a network of some 50,000 savings bank usually attached to local finance department offices, post offices, or village clubs. Interest is allowed at 3% on ordinary accounts—which by no means all bank in western countries can match.²⁹ The banking service offered is a narrow one and normally makes no provision for loans or overdrafts. However, those who are fortunate enough to be able to buy houses and durable consumer goods are able to

* This relates prior to the dismemberment of the U.S.S.R.

apply for mortgage credits, repayable over a fifteen year period, and since 1959 installment purchase has also been available.³⁰

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CHAPTER 2

HISTORY AND DEVELOPMENT OF BANKING

THE RISE

Banking has come into existence to cater for the economic needs of society and is, therefore, an offshoot of civilization. Surely there would be no need of a bank for a savage who lives on wild roots and fruits. It is this increase of human wants which give rise to the efforts of man. The history of civilization is, in fact, the history of man's effort for the satisfaction of his growing need and he, thus, advances from stage to stage. The root-grubbing stage is followed by that of hunting, The Early Palaeolithic by the new Stone Age, the Bronze by the Iron Age and so on. In this way, men instead of living a precarious life of an animal settled upon plans, took to agriculture and stored food for him and his family and here, it seems, that the conception of private property first arose.

The family was at first a self-sufficient unit and produced

all it required but gradually this system broke down and a body of professional craftsmen came into existence. This kind of change was due to the fact that the family group took the occasional help of outsiders, such as carpenters and cobblers who were supplied with the necessary materials by the family group. These workers in the course of time, specialized themselves in their professions and, thus, were formed into autonomous craftsman and began to work in their places with their own tools and their own materials and disposed of their goods in their own shops. This marks the stage when wealth began to accumulate in their hands which necessitated safe keeping and later on, led to lending and borrowing, the starting point of banking. This stage of the Guild (Handicrafts) system was reached in Europe in the Middle Ages while the banks were already developed in other parts of the world long before this.¹

During this long course of history need must have been felt of a medium of exchange to replace the barter system (i.e. direct exchange of goods against goods). Exchange by barter can not occur without the double coincidence of wants and possessions. What one wants the other must possess and vice versa. Even when there is this double coincidence there would be difficulty in deciding how much of one thing ought to be exchanged for how much of the other. This difficulty is obviated if a common measure of value is arrived at and that is money. It is a standard of

value and must have been invented in the past to represent in a small bulk the large quantities of perishable goods, grain, cattle, weapons, cloth and other commodities and the concentration of wealth in small bulk would have brought about a need for some place where it would be protected against thieves. 'Since only a fool hardy robber would dare to arouse the wrath of gods, the earliest banks in the ancient were national temples such as the Greek shrines at Delphi, Delos and Ephesus',² The Babylonians are known to have used their temples as banks as early as 2000 B.C.³ and the priests derived their temporal power from their control over these financial resources.

Banks in ancient times seem to have been confined to money changing and money lending. No one can tell with certainty when banking and financial institutions were first started, yet it may be said that extensive banking actually continued in the Roman Empire.⁴ The Western system of banking and finance stems directly from the trading operations carried on by Oriental peoples over the bridge from India to the near East. The ethnic identity of these tribes is still obscure, although excavations in the Tigris and Euphrates valleys, particularly of the ancient cities of Babylonia, lead to a belief that a non semitic nation of probably Indian origin established trade routes between Asia Minor and the Far East as early as 5000 B.C. They are known as the Sumerians and are referred to as the inhabitants

of the land of Shinar in the Old Testament account of the Babylonian cities of Babel, Erach, Accad and Calneh. Babylonian records show that these people were carrying on surprisingly complex system of lending, borrowing, holding money on deposit, and providing letters of credit long before 2,500 B.C.⁵

European banking came to an end with the fall of Rome, although banking continued in other parts of the world. But rudiments of banking were retained in Europe, first by firms of Jews who braved the discipline of both Church and State by lending money at interest, later by fraternities of monks, and still later by guilds of goldsmiths and merchants.⁶

BANKING DURING THE RENAISSANCE

Following the capture of Constantinople in 1204, the goldsmiths of Lombardy become specially influential in financial circles and established banks in many European cities.⁷ Among the great commercial cities of the Middle Ages, Venice became of outstanding importance because of her merchant fleet which maintained contact with all parts of the then known world.

Florence which was the capital of Lombardy, a province in North Italy, boasted of a large number of prominent bankers, the most famous of whom were the Medici. These

Lombards were much troubled in the 13th century with internecine wars which led to their migration to more settled countries such as Belgium, France and England. They built a street in London and established banking among other pursuits, thus making the name of Lombard Street famous.⁸

A little later, Deposit Banking and Exchange Banking flourished on the continent of Europe. The Banco di Rialto was the first public bank started in Venice in the year 1584, which did business both in the deposit and exchange branches. The bank of Sweden was established in the year 1556. It is now known as the state Bank of Sweden. This Bank has the credit of having invented Bank notes. Exchange Banks were started in Amsterdam in the year 1609 and in Hamburg in 1690, the object of which was to do foreign exchange business, as well as finance the trade of their country with foreign countries. Later they began to do deposit banking.⁹

MODERN BANKING

The commercial revolution of the sixteenth and seventeenth centuries caused by the discovery of America and other sea routes, was a prelude to the later Industrial Revolution in England. Industrial Revolution gave a fillip to the production of wealth and to the expansion of internal and external trade. This has ushered in a new era in the

system of banking which reflects the growing dependence of people in every country on ever other country for supplies of essential materials and communication, which bring the most remote countries into frequent contact with other parts of the world.

Perhaps the most striking feature in the structure of modern FINANCE is the employment through credit institutions of accumulated wealth. Loans based on deposit funds provide financial support for the varied business and industrial enterprises in which men engage, Financial institutions would be severely limited in the extent of their services if they made use only of the capital invested in their own shares. If they could only hold and repay on demand the wealth placed in their keeping by depositors, accepting a fee for such service, wealth would tend to become static and self consuming. Through credit, the accumulations of wealth, represented by bank deposits, have become a dynamic force in the Modern world. Banking systems not only make the actual value of their deposit services available for us, but they have multiplied the effective use of such funds by a system of discount and reserve which is of a comparatively recent origin.¹⁰ Commercial banks perform all these functions and are considered to be the chief product of this age.

It is of significance to note that the credit of planting the

seed of modern banking in England belongs to the goldsmiths. They were the first bankers in London. In the days of civil war in England, when the Cavaliers and the Round Heads were fighting, people were compelled to deposit for safety their valuables with goldsmiths who had strong boxes and other arrangements for this purpose. This developed into a custom and the merchants also started depositing their cash with these goldsmiths who used to charge a commission for safe keeping. But with the passage of time the goldsmiths began to use this money and keep current accounts. Thus it is stated that banking in England began to grow somewhere between 1642 to 1645.¹¹

The goldsmiths issued receipts promising to pay the value deposited on demand. Later on these receipts become mere promises to pay and when the goldsmiths ultimately began to do banking business, they become full time professional bankers. They began to keep passbooks which were handed to the depositors who could draw drafts on the banker after being guided by the passbooks. This formed the first step towards the ultimate use of cheques.¹²

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CHAPTER 3

COMMERCIAL BANKS

THE DEFINITION

There is no satisfactory definition of a bank and the term bank, as such may apply to an organisation, a financial institution operated by an individual as also proprietor, or it may be a partnership, a corporation, or other types of association.¹ In modern use it is an establishment for the custody of money received from, or on behalf of, its customers, whose drafts it has to honour and pay.² The principal function of a bank isto bring into a common fund or pool the idle money of the general public., for the purpose of making advances to others, to gain a return in the from of interest and dividends.³ Banks are sometimes classified according to the nature of their ownership, and sometimes according to the source of their charters. but the most common classification is according to the purpose they serve. In this way there are many kinds of banks. If they are looked upon essentially as receivers of demand

deposits then commercial banks alone stand distinct from others. A commercial bank is distinguished by the fact that it receives deposits from the general public that are payable on the written demands of the individual depositors.⁴ Unlike investment banks which receive time deposits and, therefore, can give long term loans, commercial banks have to devote most of their lending capacity to the giving of short term loans.

DEMAND DEPOSITS

The demand deposits of commercial banks result from: (1) cash placed in banks by depositors (2) claims to money, like cheques, placed in depositors accounts (these cheques are collected, by depositary banks from debtor banks through clearing agencies) upon other banking institutions, (3) giving of loans, and (4) purchase of investment securities. It is only with respect to the latter two sources of deposits that we may say commercial banks create money,⁵ for their lending operations bring into existence new demand deposits, against which the borrower may draw cheques, so they are as good as money.

The first two kinds of deposits may be called primary demand deposits as they result from cash and claims to money placed in depositors' accounts while the latter two are derivative or new demand deposits resulting from bank loan and investment operations. So the outstanding feature

of commercial banks is their ability to create new demand deposits. When the commercial bank makes a loan it places the funds in the customer's (Borrower's) deposit account when they become available to the Borrower for disbursement by cheque.⁶ Similarly if it purchases a security, it pays by crediting the seller's account with the amount agreed upon. Such are the demand deposits created by commercial banks. They are, so to say the promises of commercial banks to pay which count a great deal. This is further illustrated by the following example:

A businessman, for instance, may be unable to purchase goods on credit because he is not well known or because it is the established policy of his suppliers to require immediate payment, or a corporation may be unable to obtain additional credit facilities in direct exchange for its bonds; but if a bank gives its own promise to pay on demand in exchange of the businessman's promisory note or the corporation's bonds, the businessman can get his goods and the corporation its credit facilities. The credit of the businessman and the corporation is, thus, monetized because the bank's promise to pay on demand, given in exchange for the note and bonds, is readily accepted as a money medium or 'bank money'.

DEMAND DEPOSITS AS MONEY

A thing generally accepted as a medium of exchange or

a standard of value may be called money and the bank demand deposits satisfy this requirement.⁷ A person, for instance, may hesitate to accept a cheque drawn by an unknown party, he ordinarily shows no reluctance whatsoever in accepting a bank demand deposit offered by a buyer or a debtor. So it seems quite logical to place bank demand deposit in the category as money.⁸ But time deposits can not be regarded as money because they are not used as mediums of exchange or as a standard of value. The difference between the use of demand deposits and the use of time deposits may very well be understood by the following example: A who is buying some goods for his shop gives B, the owner of goods, a cheque on his demand deposit ordering the bank to pay all or a part of his balance to B. When the latter presents the cheque let us say to the same bank, the bank merely transfers the balance from A's account to B's. The payment B received from A, is included in B's, deposit account, and now B, in paying the price of a car may draw a cheque against his deposit account and forward it to C, the owner of the car. Thus B, employs the bank demand deposit to exchange goods for the car without calling into use any other kind of money. if A holds a time deposit account, he can not write on the bank to transfer all or a portion of his balance to B as it is necessary for him to visit the bank, present his passbook and withdraw his deposit in some type of money.

Thus, the time deposits of investment banks can not be transferred from one person to another whereas demand deposits of commercial banks can easily be transferred. The distinction between a commercial bank and an investment bank is that whereas the former can transfer deposits from one place to another and from one person to another person, the latter can not. Commercial banks, therefore, perform important functions through lending money and providing the machinery for transferring deposits.⁹ They not only create money in the form of new deposits but also make possible payment of money obligations regardless of size by mere transfer of slips of paper, and such slips of paper can be used whether payer and payee occupy adjacent places of business or whether they are thousands of miles apart.¹⁰

For the above reasons, commercial banks occupy a most important position in the modern economic world. They are manufactories of credit¹¹ which serves the community and keeps the wheels of commerce and industry revolving. By offering opportunities for investment and safe custody of deposits, they stimulate the habit of thrift or saving, and discourage hoarding or the unproductive use of surplus wealth, thus promoting investment and the growth of capital. A wise banking policy may go a long way towards mitigating the shocks of an economic crisis, while a banking system, if badly constructed or badly handled, is capable of inflicting great harm on trade and industry and may even upset the whole economy.

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CHAPTER 4

LOANS AND ADVANCES

THE BUSINESS OF A COMMERCIAL BANK

As we have already noticed, the first business of a commercial bank is to receive deposits from public in order to increase its working capital beyond its own share capital for the purpose of making loans and investments. It pays a lower rate of interest on the deposits which it receives than what it charges in its turn to its customers who borrow from it. This difference constitutes its profit. It usually issues short term loans because the deposits which it makes advances are mostly self liquidating so that it may have liquidity enough to meet the demands at any one time.

Short term loan is for a year or less than a year or payable on demand. In theory, deposit banking of commercial banks rests on the principal that the bank's assets should be deployed only in forms that can be quickly realized.¹ Thus, advances to individuals and firms should desirably be self

liquidating, for example through the financing of stocks that will be subsequently sold. Equally, investment should not be a 'risk' capital such as industrial shares or in real estate, but as far as possible only in short-term commercial paper which can be readily sold without unduly fluctuating in value. But in practice, these principles are not followed to the letter. Short term loans are, at times, converted into those of long-term according to the needs and requirements of the contracting parties.

TYPES OF LOANS

The loans may be classified

- (1) on the basis of the length of time,
 - (a) long-term over five,
 - (b) intermediate-term, one to five years,
 - (c) short-term, less than a year or payable on demand:
- (2) on the basis of purpose,
 - (a) *productive*- for example, loans for advancement of trade and industry
 - (b) *unproductive*-loans granted to individuals for purchasing automobiles, television, radio sets and household furniture etc. These are also called as consumer loans.

- (3) on the basis of securities,
 - (a) secured against securities
 - (b) unsecured or clean — an overdraft allowed by a banker to his customer without requiring some tangible security.

The simplest form of loan is the clean advance on the personal note of a borrower, called the single-name paper. When such a note is endorsed by a friend or business associate of the borrower it is called a two-name paper. Such endorsements may be multiplied, thus adding to the value of security. As opposed to such loans there are collateral loans advanced against promissory notes supported by the pledging of stock or bonds. These are usually easily marketable bonds. Obviously this sort of loans are more acceptable to banks than where security is only personal.

Discounting of commercial paper, promissory notes, and bills of exchange, is the most acceptable form of investment for banks. The essential qualities of commercial paper are: short-term maturity (three or six months), automatic or self-liquidating nature, and non-speculativeness in origin and purpose of use.² The term commercial paper generally applies to notes, bills of exchange and acceptances³ which are negotiable instruments and recognized by law. This term is also applied to such instruments as bills of

lading and warehouse receipts on the basis of which credit is often extended to wholesale merchants. It is sometimes used loosely for contracts and agreements as well but this usage is not strictly correct since the term is properly applied only to instruments used in place of money in business transactions.⁴

There is yet another type of loan called cash credit which suits small merchants, farmers and artisans. This consists of an arrangement under which a customer is allowed advances up to a certain limit either on his personal security or on the guarantee of another person. Here the customer draws on the bank in small instalments and pays interest on the amount actually drawn.

On the London money market some loans are referred to as 'money at call'. These are the demand loans repayable at the option of the bank. These are also loans for very short periods—money at short notice (7 days) which are advanced to bill brokers and stock brokers.⁵

A prudent banker making advances takes into consideration the character and business integrity of the borrower, his capacity to borrow, the amount involved and the purpose for which it is required, the duration of the advances, the source of repayment and last but not least in the security offered.

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CHAPTER 5

SECURITIES

THE DEFINITION

Security in its real sense is a protection for the creditor against a partial or total loss if the debtor proves to be a defaulter or fails to repay the loan. The object of a security is to give a certain right or interest to a creditor whereby he is able to recover the amount of the debt which is owed to him more easily than an action at law, if the debtor is in fault.¹

As defined by securities Act of 1933, the term security means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate or participation in any profit making agreements, collateral trust certificates, recognition certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of interest in property, tangible or intangible, or in general any instrument commonly known as security.²

CLASSES

There are various kinds of securities offered by borrowers to the banker as cover for advances made to them. Some borrowers tender stocks and shares, others guarantees by responsible parties, others title deeds, other life policies, other again bills of exchange, promissory notes and documents of titles to goods. Customers less fortunate may have nothing better to offer than second or even third mortgages, shares partly paid up, undeveloped building land, bills of sale, mortgages on mines, brick fields and other wasting properties, and reversions.³ The latter kinds of securities generally fail to attract a banker as they lack one or other necessary requisites to cover a loan whereas the first named securities are more valuable from a banker's point of view. We shall deal with some of the important kinds of securities.

a) Stock Exchange Securities:

This sort of securities comprise Debentures, Bonds, Scrip, stock and Share certificates issued by Joint Stock and other companies, by public authorities and by governments.⁴ These are the documents commonly offered to bankers as they are readily marketable, easily transferable and some of them fully negotiable. Bonds payable to bearer, scrip payable to bearer, share warrants payable to bearer, treasury bills are all fully negotiable instruments

and their deposit with the bearer gives him a complete title, but it is the practice to take a memorandum of deposit showing the purpose of the deposit, and containing a clause giving the banker a power of sale if it should be necessary to realize them.

To effect a security of share in favour of a banker, share certificates are frequently deposited together with blank transfer forms against the banker's advances. This is the form of a pledge the underlying idea being that if the borrower does not pay the loan in time, the banker can sell the shares and recover his principal and interest out of the proceeds, handing over the surplus to the borrower.

(b) Guarantees:

A guarantee is a written promise made by one person to be collaterally answerable for the debt, default or miscarriage of another person.⁵ The liability of the guarantor is only collateral, the original debtor by this promise is not released from his liability. Guarantee is one of the forms of security and its value as a security largely depends upon the financial credit and position of the guarantor and also on the terms and conditions of the guarantee.

(c) Title Deeds:

Title deeds are the documents relating to land or interest in land. The word 'land' as a legal term comprises not only

the surface of the soil, but everything above, including water, and everything below it. The term also comprises all buildings erected on the land, all timber and other vegetable products growing upon it and all mineral and other deposits embedded in it, and many kinds of right connected with land, such as rent charges, rights of way and other easements and rights of pasturage.⁶

(d) Documents of Title to Goods:

Goods may be accepted as security for loans. This is effected by taking actual or constructive possession and by deposits of the documents of title representing them. The chief Acts regulating these documents are the Factors Act, 1889, and the Sale of Goods Act, 1893. Factors Act defines documents of title as including any bill of lading, dock warrant, ware-house keeper's certificate, and warrant or order for the delivery of goods and other documents used in the ordinary course of business as proof of the possession or control of goods, or authorising or purporting to authorise, either by endorsement or by delivery, the possessor of the documents to transfer or receive goods thereby represented'.⁷

(e) Life Policies:

Life policies are often offered to bankers as securities and the banker makes advances on the footing of their 'surrender value' which depends on the age of the assured

and the duration of the policy, and is greater on policies of long duration and on lives where the age is considerably advanced than those of short duration and in young lives. The actual surrender value is always ascribed from the company.

(f) Bills of Exchange and Promissory notes:

These are called commercial papers with which we have dealt in the preceding chapter. They are securities of self liquidating nature and therefore most welcome to the banker.

(g) Debts:

Debts may be assigned to the banker and, thus, may be available as security in which case the banker will have to give a notice of such assignment to the debtor otherwise he will not be able to sue the debtor in his own name and the debtor may be at liberty to make payment to the assignor.⁸

(h) Bills of Sale:

A bill of sale is a document under seal which, for consideration, transfer the title to personal chattels from one person to another. The person given the bill of sale is called the grantor, and the person to whom it is given is called the grantee. Absolute bills of sale pass the property to the transferee; conditional bills of sale pass it by way of

security for the payment of money. We are concerned, here, with conditional bills of sale which are in the nature of a mortgage of personal chattels (goods, animal stock, household furniture and other articles capable of complete transfer by delivery). See Bills of Sale Act, 1878, S. 4.

Bills of sale are not, as a rule, acceptable to bankers as security⁹ and when a bill of sale is registered against one of his customers, it is regarded by the banker that his customer is in a financial stringency.

In all the cases referred to above even when the document of charge gives the banker a power to realize securities without reference to the borrower or the person who has deposited the security, he (the Banker) has to demand, before selling the security, repayment of the loan and give reasonable notice that he would, otherwise, sell the security.

Banker is accountable for surplus, if any, after the debt has been discharged, but he has a right of set off against such surplus if the borrower owes him other debts, provided always that he received no notice of a second charge upon the security.

Briefly, a banker making an advance may be secured by either or all of these methods, viz. (1) a mortgage, (2) pledge, and (3) a lien.

Mortgage, pledge and lien:

These are, in the main, three methods of creating a charge in favour of the banker. In each case the banker does not become absolute owner of the property, but has rights over the property until the debt to him is paid.¹¹

Mortgage:

Mortgage is a charge given by a borrower to a lender upon a part or the whole of his property. There are two kinds of mortgages: (1) Legal Mortgage, (2) Equitable Mortgage.

With a legal mortgage a banker has control of the property, if the borrower fails to repay the advance made to him. But with the equitable mortgage—that is a deposit of the title deeds with, as a rule, a memorandum of deposit—the banker will, unless the borrower gives a legal mortgage when required, or unless a power of attorney or a declaration of trust is incorporated in the memorandum, be at much trouble and expense before he obtains the sanction of the court to dispose of the property.¹²

Property of any kind may be the subject of a mortgage, but it generally applies to land or interest in land which is to be charged under, while a mortgage of goods is called Bill of Sale.¹³

The chief advantage of a legal mortgage is in that the mortgagee has power to sell the property or to appoint a receiver to collect the rents arising from it, if the debt is not paid. These powers may be exercised without going to a court.¹⁴ On the other hand, a banker is in a much less powerful position if he takes an equitable mortgage, for he can neither sell the property nor appoint a receiver without the help of the court. But the difficulty is that the borrower usually objects to executing a legal mortgage on one of two grounds. First, the ad valorem stamp duty on a legal mortgage is very high compared with that of an equitable mortgage under hand. Secondly, he is reluctant to do so because even after the debt is repaid, the mortgage deed, duly discharged, forms part of his title to the property and is a clear evidence to any one who may purchase from him that he borrowed money upon mortgage. Such is not the case with equitable mortgage.

Therefore, some of the bankers resort to a special type of equitable mortgage under seal which virtually gives the Bank some powers as does a legal mortgage. In order to have the power to sell the property and to appoint a receiver either or both of the following methods are adopted: (1) a power of attorney whereby the mortgager irrevocably appoints some one (usually an official of the bank) to sell or grant leases of the property as his agent or to execute a legal mortgage thereof, (2) a declaration of trust wherein

the mortgagee acknowledges that he holds the property upon trust for the bank, and at the same time, empowers the bank to remove him from the trust and to appoint some other person as trustee.¹⁵

Pledge:

A pledge or pawn is a delivery of chattels or choses in action by a debtor to his creditor as security for his debt. It is to be distinguished from a mortgage in that, whilst possession of the thing passes to the pledgee, the property in the thing (i.e. the legal ownership) remains with the pledger. With a mortgage of things other than land, the property in the thing passes to the mortgagee whilst the possession of it may remain with the mortgager.

A pledge gives a right of sale if default is made in payment of the debt within a reasonable time after demand if no time for payment is expressed. A pledge must be distinguished from a lien. The former arises from express agreement; the latter by implication.¹⁶

Lien:

Lien is the right to retain property belonging to another until a debt from the latter is paid. This is a possessory lien.

A possessory lien is of two kinds: particular and general. A particular lien is the right to retain goods in respect of

which the debt was incurred. For example, a carrier has a lien on goods entrusted to him for transport, a watchmaker has a lien on articles left for repair in respect of the cost thereof. A general lien is a right of retainer not only for a debt incurred for particular goods but for the general balance due. Thus bankers, solicitors, stock brokers, in certain circumstances may have a lien on clients' securities, etc; for all moneys due.

A banker's lien is a special form of general lien, for it includes a right of sale after reasonable notice.¹⁷ It is a right of a banker to retain such of his customer's property as comes into his hands in the ordinary course of business as a banker; it is an implied pledge.

The securities charged and taken in the above manner may easily be realized, in case of default in payment by the debtor. The banker is, thus, put in funds to make loans again and originate credit. The question is: what is credit and how it is originated ?

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CHAPTER 6

CREDIT

THE DEFINITION

Credit is a term derived from the latin word 'Credo',¹ meaning 'I believe', In other words it is belief in the ability of a person to pay. To put it more appropriately it is the weight attached to a person's promise. Thus credit is sometimes described merely as a promise to pay money or as permission to use the capital of another person.² Abstractly it is referred to as 'the power which one person has to induce another to put economic goods at his disposal, for a time, on promise of future payment'.³ Bank credit, therefore, relates to the trustworthiness which it enjoys by reason of its capital structure and deposits as well as to the credit it procures from other sources. The sources of a Bank are vast and varied. it may obtain credit from its correspondent banks, from the central bank, from government agencies and from the open market through

the sale of acceptances. On this account, the reliance placed in banks is very great so much so that their cheques and drafts function as currency and have replaced currency.

Because of the confidence of the public in the soundness of the bankers, their promises to pay are invested with the qualities of money. The public uses these promises to make its purchases and to pay its debts. When the banks make a loan, they do so by increasing the number of their promises to pay in return for the borrower's securities which are, in fact, the banks' assets and out of which they make profits. The Loan is, thus, no cash payment but only a promise to pay or in other words a demand deposit created in favour of the borrower against which he can draw. Briefly, the bank's credit is comprehensive of all kinds of promises to pay of banking institutions, including demand deposit, time deposit, notes, acceptances, letters of credit, bonds etc'.⁴

By their promises to pay, the banks collect money from the public and lend it to enterprisers or businessmen. Induced by such promises, business firms, government bodies, other organisations and individuals keep a large portion of their money balances with the banks as demand deposits. Such balances simply represent the obligations of the banks to pay but the depositors consider them as money in the bank, to the depositors the important condition is that

they can demand payment, in legal tender money, at a short notice and that by writing cheques they can order the banks to transfer all or a portion of balances to others.

Here it should be noted that depositors do not draw their whole amount all at once. They usually draw it at intervals as and when it is required. So the banks make it a rule to keep a portion of these deposits in cash to meet the demands of their depositors which is called a minimum of reserve in proportion to their deposit liabilities. This is what the Central banks insist upon so that the cash of Commercial banks should not fall below a certain proportion of their deposit liabilities.

A member of a central banking system is, therefore, required to deposit a fraction of its deposit funds with the central bank as a cash reserve and it is free to lend the remaining funds. Out of these remaining funds they start lending operations and may create money upto the total of about twelve and a half times their cash reserves.⁵ Suppose a bank holds £100 in cash and is required to keep 8% of its cash reserve in the central bank, this will enable the bank to increase its lending as such as twelve and a half times by setting apart, on each lending, the required cash ratio of 8% until the effect of the lending of the original £100 has petered out.⁶ This is made possible, since the bank, in lending does not pay in cash. If it, for instance, grants a loan

of £100 to A, it does not pay A in cash, but simply credits his account with this sum and thus creates demand deposit for A, against which he can draw.

The loaning operation is nothing but promises of the bank to pay in the form of demand deposits which is described as credit. Such demand deposits are treated as money against which cheques may be drawn. It is therefore, said that a bank deals in money and instruments of credit.

CREDIT INSTRUMENTS⁷

The promise to pay in the future takes various forms which include verbal and book credits. Verbal credit is a long granted on the mere verbal promise of the borrower to make payment at a certain time. 'Book credit' or Book debits' is the credit granted and entered in the books (ledger) of the creditor. It is, so to say, credit on account. The entry in the ledger is evidence of the credit granted. The principal credit instruments are promissory notes, cheques and bills of exchange.

A promissory note is an unconditional promise in writing made by one person to another signed by the maker, engaging to pay either on demand or at the expiration of a specified period a certain sum of money to, or, to the order of, a specified person or to bearer. The payee can endorse (sign) the note and thus make it negotiable.

Another important class of promissory note comprises the currency notes issued either by the government or by some authorized institution like the Bank of England. These notes are payable on demand and form part of the regular legal tender currency of most countries. Promissory notes are also extensively used in connection with the inland or interland trade of country, and are included in 'commercial paper'.

A cheque is a written order signed by a depositor— an individual or a firm— on his bank, ordering the bank, on demand, to pay a certain sum of money to a third person or to the drawer himself or his order, or to the bearer. Sometimes a cheque is crossed, i. e. two lines are drawn obliquely across the cheque. Like the ordinary cheque the crossed cheque is also drawn upon a bank, but it can be paid only to the bank to whom it is crossed. The name of the bank in whose favour it is crossed is sometimes written between the two lines drawn obliquely across the cheque. Such a cheque is generally carried to account and is safer than the ordinary cheque even if it is stolen it is of no use to the thief since only the bank in whose favour it is crossed can obtain payment on it. A cheque drawn by one bank upon another is known as banker's draft.

A bill of exchange is an unconditional order by one person (called the 'drawer') drawn on another person

(called the 'drawee') Instructing the latter to pay certain sum of money to or to the order of a specified person or to bearer (called the payee). But unlike a cheque a bill of exchange is not necessarily payable on demand or at sight, but at some future date, it may be after thirty days or sixty days or ninety days, but generally not longer than six months. It is called a 'sight bill' if the payment is to be made as soon as the drawee has seen it (i. e. on demand). If the payment is to be made at the expiration of a fixed period it is called a time (usance) bill. The person on whom the bill is drawn may either accept the bill by signing it as 'accepted' or decline to make payment (signing 'protested') The acceptor becomes legally liable to make the payment due on the bill. If the drawer and the drawee are in the same country the bill is called a domestic bill: if in different countries, it is called a foreign bill (an export or import bill).

CREDIT INSTRUMENTS AS A MEDIUM OF EXCHANGE

Cheques and bills of exchange serve as medium of exchange as a vast volume of transactions is conducted by means of such instruments. They are negotiable instruments and can be transferred by the payee or the person in whose favour they are drawn by mere endorsement to another person. In the case of cheques made payable to the bearer, the transfer is effected merely by delivery from hand to

hand as in the case of a bank note. Thus before a cheque or a bill of exchange is finally cashed or 'retired' it may have passed a number of times from hand to hand, being used like money. Cash or use of actual money is, thus, dispensed with so far as the intermediate transactions are concerned.

FUNCTIONS OF CREDIT

The principal use of credit is that it enables men of enterprise an initiative to embark upon large scale ventures on borrowed capital. It mobilizes the existing capital and makes its more effective use possible.⁸ It enables production to be initiated long in advance of demand, i. e. in advance of the sales of the product to the consumer.

ABUSES OF CREDIT

Expansion of credit, no doubt, helps a great deal to supply the needs of businessmen and enterprisers but it if exceeds the limits there is danger to the economics stability of society as speculation is encouraged, over production ensues. The unwise use of credit may also enable the weakness of business concerns to be concealed for quite a long time making the inevitable crash all the more disastrous when it comes. An over expansion of credit and apparent prosperity may only be followed by a sharp deflation. Banking and business concerns may find their assets frozen when the business situation slumps.⁹ Hence the need for Central Banks to regulate credit.

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CHAPTER 7

CENTRAL BANK

THE RISE

As we have already noticed, commercial banks grant loans and buy investment securities and thereby create new money in the form of demand deposits. To the extent that newly created demand deposits are spent in hiring idle factors of production to increase the output of the economic system, the commercial banks act wisely, but to the extent that they are used merely to bid up the prices of the factors of production already employed, the expansion of deposits must be regarded as pernicious. In the former instance the welfare of the general public is promoted because larger supplies of goods become available in the market; but in the latter instance the price increases produce many maladjustments throughout the economic system unaccompanied by any significant benefits.¹

It is no doubt injurious to allow commercial banks to

continue to create new demand deposits after a stage of reasonably full employment in the economy has been achieved. The enormous expansion of credit through creation of demand deposits may be imagined by the fact that about 80% of money used in Great Britain consisted of such deposits in 1959.² The deposits are created by commercial banks in the expectation that they will not be called upon to fulfil their promises (to pay) to any great extent at any one time. When this expectation has been disappointed disastrous results have sometimes occurred.³

Whenever a bank lends to a businessman - whether by loan or overdraft - or to the Government by the purchase of Government stock or Treasury Bills, this results in a corresponding increase in the total of demand deposits. The Bank simply notes the amount and is then prepared to honour the customer's cheques. To control over-expansion of such credit, Central Banks have come into existence.

The International Financial Conference, held at Brussels in 1920, passed a resolution that in countries where there is no Central Bank of issue, one such bank should be established.⁴ The idea implied is that there is a close connection between the maintenance of financial stability and a Central Bank. Several European countries such as England, France, Germany and Switzerland had already developed a strong central banking system. Even the

United States, the home of decentralized banking, adopted the new system under the Federal Reserve Act of 1913. At the end of World War I several central banks were established in Central and South American states, in South Africa, New Zealand, Canada and in countries that previously formed part of the Austrian and Russian empires. In India, the Reserve Bank was established in April 1935.

In the 19th century and the early years of the 20th, it was believed that central banks could best serve the public interest if they operated free from political intervention, but their failure to cope with the world depression of the 1930's pointed to the need for overhauling the traditional concepts of central banking. The result was that some central banks were nationalized and others subjected to regulations to a point, where they became more or less integrated with government policy.⁵ The common feature of banking system in the modern world is a central bank in every country.⁶

THE FUNCTIONS

Central Banks act as fiscal agents for their Governments and are custodian of treasury funds. They issue paper currency, carry the gold reserves, serve as depositaries for other banks, and, as the banks of last resort, bear the responsibility for controlling the supply of credit.

In most countries, the central bank is the exclusive issuer of the principal kind of hand-to-hand paper money, namely, bank notes—paper money in circulation. Again, most of the deposit liabilities of the central bank constitute the principal reserves of the commercial banks on the basis of which the latter expand their demand deposits. The significant fact here is that central bank, by central kinds of action, may vary the total quantity of available reserves, so that, in effect, it has control over the to total volume of demand deposits. Having the power to regulate note issues and the volume of demand deposits, the central bank is, thus, in a position to control the overall money supply.

In almost all instances, moreover, the central bank is the principal adviser of the national government upon all matters pertaining to money, banking, and management of the public debt. Because the enormous government financial operations of modern times profoundly effect every phase of economic life, policy decisions must be made with extreme care, and because the central bank is empowered to control money supply, it is in a strategic position to guide financial policy.⁷

The Central Bank is mainly a bankers' bank.⁸ It offers rediscounting facilities or makes short term advances against approved securities to its member banks and thus makes credit available to them. It supplies the market with

cash and maintains the stability of the external value of the currency unit. It has to arrange to buy or sell foreign exchange or gold so as to control directly the exchange rates, or change its bank rate so as to produce an indirect effect on the rates of foreign exchange. In order to maintain internal stability a central bank has to keep the internal price level stable by a proper regulation of the volume of currency and credit.

Thus the Central Bank is distinct from ordinary commercial banks and its policy is directed not so much to making profits and maintaining its own solvency, as to regulating the credit machinery and maintaining the solvency of the banking system as a whole by functioning as the lender of last resort. For these reasons Central Banks do not usually allow interest on deposits and avoid direct dealings with the public in order to escape competition with commercial banks.⁹

WEAPONS OF THE CENTRAL BANK

1. Alteration in the reserve Ratios of member Banks:

We have already seen that member banks have to keep a certain percentage of their deposits as cash reserves with the central bank. This is just to maintain the liquidity and solvency of the member banks.¹⁰ Credit is controlled by varying the ratios of these reserves. The Central Bank can

expand credit by lowering the ratios and contract credit by raising them. For example, Bank of England, in 1960, called on the banks to place with it special deposits, which were not to rank as liquid assets but earned interest at the Treasury Bill rate. The object of such steps was to reduce the ability of the banks to expand further credits through advances. This was the newest weapon of credit control, the oldest weapon being 'Bank rate' i. e. rediscount rate of the bank of England at which it will purchase bills from the discount market when the market is short of funds.¹¹

2. *Bank rate:*

Bank rate is usually considered an indispensable tool of control, for it ensures both that the market can always find a lender at last resort and that the central bank, by acting on the price at which it lends, can in this way influence the whole structure of market rates.¹² Its operation may be thus explained. A Central Bank is liable to meet both external and internal drains on its reserve, and seeks to protect its reserve by raising its official rate for the discounting of bills. A rise in bank rate is followed by other banks raising their rate of discount also,¹³ so that there is a decrease in the volume of bills presented for discount and of fresh loans.

3. *Open market Operations:*

To make the bank rate policy more effective, a Central Bank may resort to open market operations. These consist,

in the Central Bank directly selling and buying securities, bills and government stock in the open market. Thus if it desires to create tight money conditions and check speculation, it will sell securities to the public for cash and, in this way, decrease its supply in the market. If, on the other hand, the Central Bank wishes to encourage easy money conditions, it will buy securities from the public and thus expand currency and credit and put additional funds into the market, thereby increasing the cash reserves of member banks and enabling them to expand the volume of credit issued by them.

In short, the Central Bank occupies a pivotal position in the monetary and banking structure of the country in which it operates. It is vested with special powers to regulate credit and currency. After World War I, the need for cooperation among the leading central banks of the world regarding monetary policy was increasingly felt. Such a policy seemed to be facilitated by the establishments in 1930, of the Bank for International Settlement at Basil (under the famous Young Plan). It was contemplated that this bank shall develop into a Central Bank for the Central Banks of the world. But the high hopes of international cooperation could not be materialized due to the dominating influence of economic nationalism resulting in the failure of the World Economic Monetary Conference of 1933. The division of countries into monetary groups and the

deterioration of international relationship culminated in World War II.

The economy of the whole world was shattered by this war, hence post war reconstruction plans postulating a high degree of international cooperation in currency and financial matters occupied the minds of the economic and financial experts with the result that the International Bank for Reconstruction and Development (I.B.R.D.) which is also known as the World Bank was established together with the International Monetary Fund (I.M.F.) in 1944, by 44 important nations, following the Bretton Woods Conference in U.S.A. These two international institutions were considered necessary to restore and expand international trade and to secure development of war damaged and backward countries.¹⁴

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BANKING AND ISLAMIC LAW

CHAPTER 8

THE WORLD BANK

AIMS AND OBJECTS

The object of the Bank is to aid reconstruction in countries ravaged by World War II, and to promote international flow of all types of long term capital for production purposes. It rarely makes loans directly out of its funds. The called up capital does not provide for all the loans and the bank issues debentures from time to time to raise money for relending, guaranteed by the security of the Bank's capital. Thus the Bank may be regarded simply as a mechanism whereby funds may be made available for reconstruction and development in other countries, with the normal risk of international investment minimised through the Bank's management and supervision and the guarantee furnished by capital subscriptions of its members.²¹

The Bank is managed by a full time president and staff

who derive their authority from 12 executive Directors (out of whom 5 represent members with the largest capital subscription, viz U.S.A. China, France and India). The Executive Directors are a sort of an inner council appointed by the Board of Governors to which each member country sends one representative.

The Bank's authorized capital is the equivalent of \$21 billion, of which the equivalent of approximately \$18.5 billion has been subscribed. Only part -about one tenth- of this, however, is paid in. Much the greater part of the Bank's Capital remains subject to call by the Bank only if required to meet its obligations arising out of borrowings or guarantees.²

To avoid the risk of defaults in repayment of the loans advanced by the Bank, it has been provided that the loans must be for productive purposes and, except in special circumstances, must be to finance the foreign exchange requirements of specific projects of reconstruction and development.³ The merits of all such projects are carefully studied and the most useful and urgent projects are dealt with first.

In order to borrow, it is not required that the borrower should be a member government. Persons other than member government, may apply for loans under the guarantee of the member government in whose territory the project is located.

PROCEDURE FOR MAKING AND ADMINISTERING LOANS

In making advances the bank prefers to have informal exploratory discussions with prospective borrowers before a formal application for loan is made. This is to know whether the project is of the type for which a loan may be granted. In general, the actual processing for loan request falls into two parts: a preliminary one, in which the Bank reviews the economic situation and prospects of the borrowing country and the relation of the project under consideration to its economic needs and potentialities, and then a more technical and critical examination of the engineering, financial and other aspects of the project and of the appropriate conditions for a loan. These two stages of investigation may proceed more or less concurrently or they may be successive, depending upon the circumstances.⁴

The preliminary investigation is to satisfy the bank that the borrower can repay the loan and the project will make a significant contribution to the economy of the borrowing country. If the project is in a country with which the Bank has had no previous experience, The Bank seeks to acquire a comprehensive picture of the structure and development of the economy. It therefore begins its study with such fundamentals as a review of the country's agricultural, mineral and industrial resources, the state of basic facilities such as transport and power, the amount and quality of

manpower resources, the pattern of external trade and payments, and the condition of internal finances. If the Bank has previously made a loan in the country or has otherwise become familiar with its economy, this preliminary comprehensive review is dispensed with and the inquiry is confined to an intensive study of recent economic developments and prospects.

Being satisfied with the preliminary investigation the Bank starts the second and more detailed investigation. Staff specialists or consultants are called upon to make a thorough examination of the technical plans for the project. A similar examination is made of the plans for financing that part of the cost of the project which is not expected to be met out of the Bank's loan. It may be necessary to check the market survey made by the borrower or if none has been made, to assist the borrower in making one. It is also necessary to examine in detail and sometimes to suggest revisions in the administrative and managerial arrangements by the borrower to carry out and operate the project.⁵

METHODS OF INVESTIGATION

Much of the work of these two investigations takes place in the Bank's headquarters. Here the Bank studies all available information about the country and the project. In addition to its own files, the Bank takes advantage of the large reservoir of source material which is made available

to it by many other institutions, national and international, public and private. Information from all these sources is supplemented by information specifically requested from the borrower.⁶

No study in the Bank's headquarters, however, can yield the benefits of an on-the-spot investigation. Therefore the Bank usually sends one or more missions to the borrowing country to familiarize itself with the project and with the economic conditions. The mission may consist of one or two persons or half a dozen persons of various qualifications. The members of mission are normally drawn from the Bank staff but, since the Bank can not keep on its permanent staff experts in each of the many fields which it may be called upon to examine, it frequently employs independent consultants for specific short time assignments, or borrows technical experts for this purpose from member governments, other international agencies or private firms.⁷

FORMAL NEGOTIATIONS

It is only when the technical investigation has been satisfactory, the Bank advises the borrowers that it is ready to begin formal negotiations for a loan. Such negotiations are with the object of reaching an agreement with regard to the project and the terms and conditions of the loan. The loan and guarantee agreements and all supporting documents are presented to the Executive Directors, together with the recommendation of the president, for their approval.

After approval by the Board of the Bank and signing of the loan agreement, it usually takes a period of several months before the agreement becomes effective. The coming into effect of the loan agreement generally depends upon the fulfilment of certain prescribed conditions. Only after the agreement has become effective can disbursements be made.⁸

Disbursements are made by the Bank according to the progress of the work and the satisfactory reports on it. These reports show that the goods and services to be financed are covered by the loan agreement and that they are reasonable in cost and of proper quality. In addition periodic visits are paid to the project by Bank staff to examine the site of the project and the progress of the work and to scrutinize the accounts of the borrower.

It is the Bank's practice to maintain a close relationship with its borrowers throughout the life of each loan. There are two main aspects to this continuing relationship. First the Bank checks to assure that loan funds are expended only for authorized goods or services and closely follows the progress of the projects. Secondly, the Bank keeps in touch during the entire life of the loan with economic and financial developments in the borrowing country through information submitted by the government, periodic visits to the country by Bank officials, and consultation and

exchange of views with the government's representatives.⁹ In short, the Bank takes all such measures which a prudent man needs in controlling his own affairs.¹⁰ Let us, now, have a brief survey of international Monetary Fund (I.M.F.) which has been established along with the World Bank.

INTERNATIONAL MONETARY FUND (I.M.F.)

The problems of international payments is the Fund's main concern. The membership of Fund is the pre-requisite to membership in the World Bank. The members subscribe to the fund, partly (75%) in their own currency and partly (25%) in gold and dollars according to their quotas. The quotas are based on their average volume of foreign trade. The members then could buy foreign exchange from the fund, as and when they need it according to a prescribed procedure. A member country can obtain from the Fund in any one year foreign currency in exchange for its own 25% of its quota.

The Fund provides for (1) short-term credit to countries to help them over temporary difficulties in their balance of payment position, (2) mechanism of adjustment to improve the long-term balance of payment position of member countries and (3) continuous machinery for international consultation and for research.

The par values of currencies of all the member countries

are expressed in terms of gold. After consulting the Fund, a member-country may change the parity of its currency (if this is necessary to correct disequilibrium) to the maximum extent of 10% even without approval of the Fund. A further change in the par value of the currency may be granted by the Fund by a majority vote. The object of this plan is to promote reasonable stability of exchange rates.

The chief object of the Fund is to secure a stable relationship as between the rates of exchange of different foreign currencies so that international trade may be revived and expanded.¹¹ It stands for the removal of foreign exchange restrictions that hamper the world trade.

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PART II

BANKING
IN
ISLAM

CHAPTER 9

AFFILIATES OF THE WORLD BANK

INTERNATIONAL FINANCE CORPORATION (I.F.C.)

The I.F.C. was formed in July 1956 and marks an important development in post-war economic cooperation. The World Bank has its limitations of functions as it operates at government level and it was, therefore, felt desirable to have an international finance institution functioning at the private level.¹

Membership of this Corporation is open only to governments which are members of the World Bank and the rate of subscription to the capital is based on the ratio of its subscription to the World Bank. The main object of the Corporation is to assist the private enterprises and to promote economic development.

With regard to the eligibility of an applicant, the

enterprise must be essentially private² in its ownership as well as management and should contribute on its own more than 50% of the funds, the balance not being available from other private resources on reasonable terms. The investment must be productive and must contribute to the development of the economy of the country where the enterprise is located. The Corporation would, therefore, insist on satisfactory proof of the production potential of enterprises requiring assistance. As the basic objective of the Corporation is to promote cooperation between investors, the Corporation's investments will be placed on a revolving basis. Therefore when an enterprise has been placed on a sound operating basis, the Corporation's assistance would be withdrawn and the funds released for help to other enterprises.³

INTERNATIONAL DEVELOPMENT ASSOCIATION (I.D.A.)

To promote economic development and increase productivity of the less developed countries, the international Development Association has been formed on 24th Sept. 1960.⁴ Its membership is open to member countries of the World Bank. By November 1966 its membership included 96 countries.

Its main object is to provide finance to meet the important development requirements on terms as it (I.D.A.) may

deem appropriate⁵ which gives I.D.A. much flexibility. Unlike the World Bank it may make advances with or without governmental guarantee, to a borrower. It may give loan on easy terms of repayment. The articles of agreement of I.D.A. were issued on 29th January 1960. They cover a wide variety of loans on a wide variety of the terms. The initial resources proposed for I.D.A. are \$1000 million. It can give loans wholly or partly repayable in the local currency at a low rate of interest. Its loans will be for high developmental priorities whether or not the project is revenue-producing or directly productive.

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CHAPTER 10

CONCEPT OF BANKING IN ISLAM

Conflicting Views: It is generally believed that there can be no banking system in Islam as interest, the cogwheel of the modern banking, is strictly prohibited. Interest encourages savings and attracts idle money of the community into the banks without which banking system is inconceivable. The orthodox islamic finance and its interest-free economy leaves no room for the establishment of the institution of *riba* (interest or usury).

Those who oppose this view assert that islam is an all embracing universal religion and has already to its credit *Bait al-Mal* (Treasury of the Muslim State), the prototype of a state owned Central Bank, performing all its functions with the exception only of note issue.¹ A developed system of banking can be had, under Islamic Law, in consonance with the spirit of Islam. The interest-free economy practised in the early days of Islam is neither capitalistic nor communistic, yet it has good features of both. It can create

a healthy society which blossomed in the past and in which there was no accumulation of wealth in a few hands, no hoarding and no profiteering. Based on the principle of 'neither do harm, nor be harmed,' it worked well and guaranteed to the poor their sustenance. Every citizen was provided with the means of livelihood, peace and prosperity reigned supreme. This was due to the fact that interest was eliminated from society once and for all.

SUGGESTIONS

The veterans of Islam propose that the banking in Islam should be based upon the principles of partnership i.e. *Mudaraba*. They say that through this system all the evils of modern banking will be abolished. It is, according to them, a system to share profit and loss equitably. The interest-free Bank will have share holders who will receive dividends out of the yearly profits. The Bank will accept deposits from the community both for safe keeping and profit-sharing purposes. A certain percentage of the deposits received shall be allocated for interest-free personal loans while the major portion will be utilized to meet the credit requirements of business and industry.

The interest-free Banks will provide credit facilities and perform all the functions of commercial banks. Being partners in business and industry they will supervise the progress of work and under the vigilance of Bank staff the

chances of loss will be minimized. The profit sharing principle will provide an incentive to the investors who will invest their money in the Bank. The partners in such Banks shall have mutual gain, and mutual loss whereas in the modern banking losses are borne by the borrower alone and the lender always stands to gain.

Speaking of the consumer loans they say that Islam has enjoined upon the well - to - do to grant such loans to the needy. Or, credit unions and cooperative societies be formed so as to provide interest-free loans to the members. Some of these veterans have gone to the extent of ascribing the responsibility of granting such loans to *Bait al-Mal* and to the Banks themselves, for they do not pay interest or dividend on current deposits.

There are others who hold that the word *Riba* does not apply to Bank interest, particularly, when it was not known before Islam. Those who assert it, seem to have ignored the fact that excess (whatsoever) over the principal amounts to *Riba* and the bank-interest is not without an excess. Further, Makkah, even before Islam, was the centre of banking (O' Leary, Arabia before Mohammad, P. 182), and had become the paradise of stock brokers, of middle men, of bankers' (Lammens, Islam, P. 15). Can it, then be contended that bank-interest is not *Riba* and was not known when it was forbidden.

Last but not least is the proposal to nationalize the banks in order to purge them of the evils of interest. As private banking leads to the cycles of booms and depressions, it is suggested that the state itself should undertake all the activities of financial institutions. There should be one State Bank with a number of branches which would not only avoid competition but also suppress all the sources of crises and crashes in the modern capitalistic society.² The profit-sharing incentive will bring in deposits for the State Bank and, if necessary, the Imam or the Head of the State may be invested with powers to impose financial contribution on the well - to - do part of the society when a contingency arises.³

The State Bank will function on the basis of *Mudaraba*. It will successfully meet all the difficulties in the way of international trade and solve the problems of exchange, bills of exchange etc. This is in a nutshell, the concept of banking in Islam, but the question is: Does Islam permit nationalization?

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CHAPTER 11

NATIONALIZATION

THE DEFINITION

The word 'nationalization' means converting a thing into property of the nation, and, in other words, to bring it under the control of State, which amounts to the use of force and interference in the right of private ownership. Can it apply to private concerns in Islam? Is it not the duty of Islamic State to see that economic activities are carried on freely?¹ Will it not, otherwise, amount to communism, despised and detested in Islam? It must be remembered that Islam is not, in any way, callous communism which abolishes private ownership and curbs the liberty of man. Islam is appreciative of human values and affords full scope to the individual to develop his personality so as to be more useful to society. An Islamic State, therefore, does not interfere with the economic activities of its subjects unless such activities are either unlawful or harmful to the society. Even then, it does not perpetuate its control but only removes what is unlawful or

harmful. To perpetuate its control would mean the negation of man's freedom. Further it would take away the very incentive to work which is a great loss to the community as a whole.

It is always cited in support of nationalization that the Prophet had declared three things- water, grass and fire- to be freely used, as common property, but those who contend so seem to have forgotten that the declaration pointed to the things which were already in free use such as water of the seas, streams and springs, wild grass, fire in the desert.² And the pastures which are often referred to as nationalized, were declared open for common use by the Prophet and thereafter by the Caliph Umar as they were common and not private lands.³ As to the things that are privately owned, it is hold by the Malikites, that one may not use grass growing on private meadows⁴ and the water of privately owned wells, basins, springs and streams is considered to be privately owned water. The owner of such water may prevent others from its use and may even sell it.⁵ And according to Hanifites and others water stored in a vessel can be sold.⁶ How can the Banks be nationalized when they are free to deal in private property of their clients and of their own and Islam is not averse to the holding of private property?⁷ Suffice it to say that Islam stands for free and not for controlled economy,⁸ and neither the Prophet, nor the Caliphs, did ever nationalize any commercial or industrial

concern. Private property is treated as sacred as human life itself.' Your lives and your property are sacred and inviolable amongst one another until the end of time' are the words of the Prophet who in his celebrated sermon of the Farewell Pilgrimage has strictly forbidden bloodshed and interference of the one with the property of the other and this has a binding force on the individual and State alike.⁹

NATIONALIZATION AND REFORM

Nationalization is always referred to in connection with reforms and reform means rectifying of something faulty. Supposing that State control is required for the removal of some abuse or wrong it will not be justified to establish such control in perpetuity. Further, reforms, in Islam, are introduced by peaceful means and not by force or coercion, Instead of force, Islam prescribes psychological treatment of evils. Force being undesirable in that the nature of man revolts against it, Islam uses persuasion and exhortation. By offering reward it stimulates obedience to God. Reward for a good act is manifold. 'God is most merciful and at the some time swift at reckoning, if He be disobeyed'¹⁰ 'He is nearer to man than his jugular vein and knows what the soul of man whisperth to him',¹¹ 'He takes into account even the intent of man and metes out punishment and reward accordingly.'¹²

These and others are the verses of the Qur'an which inspire in man feelings of hope and horror—hope for the

reward and horror of punishment in the Hereafter and even in this world in the shape of distress and disaster. Under the influence of hope and horror man begins to act righteously. The merit of the Qur'an lies in this, that it builds the mind of man in such a way that he becomes God-conscious and this consciousness alone is a restraint against sins and shortcomings of the individual and a panacea for the ills and evils of society. Upon such remedy depends the lasting peace and prosperity of society and not upon force and nationalization. The solution of our problem lies not so much in nationalization as in evolving a system of banking commensurate with the needs of society. Before we proceed to examine the needs of the society. Let us first see what society is according to the principles of Islam.

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CHAPTER 12

ISLAMIC SOCIETY

THE STRUCTURE

Society in its real sense, is an association for the purpose of harmonious co-existence. It is composed of individuals and their inter connected actions. Each such individual is the centre of a great number of social relations and each such relation depends on him, on his qualities, on his actions, and also affects him and modifies his qualities and his actions.¹ The moral value of society, therefore, exists in the morality of its members; hence Islam concerns itself primarily with the morality of the individual and enjoins him to believe (in God) and act righteously.

Islamic society is, thus, based upon righteousness and mutual help.² 'Help ye one another unto righteousness and piety, but help ye not one another unto sin and transgression,' is the call of the Qur'an.³ This call was adequately responded to by the Muslim community in the past. When the people

of Makkah forsook their homes and adopted voluntary exile in company with their beloved leader, their good friends in Madina gave them asylum and every kind of assistance, moral and material, Under the magnetic personality of the Prophet these two groups became like blood-brothers and they were so treated in matters of inheritance. They were, indeed, the best of people evolved for mankind, enjoining what is right and forbidding what is wrong and believing in God.⁴ They preferred others above themselves though poverty became their lot.⁵ Their life was simple, their wants limited and they solved economic problems by mutual help and sacrifice. But things are changed now and the advance of civilization has given rise to new problems and a multiplicity of needs for which we have to depend upon others.

THE PRESENT CONDITION OF SOCIETY

Society, at present, consists of Modernists on the one hand and the Orthodox Muslims on the other. The Modernists stand for a complete change in the outlook on life and stress the need for rational approach to the Qur'an and its re-interpretation in modern light. Their persistent demand is that the bank interest be allowed in all its forms.

To the orthodox Muslim the *Sharia* is still as it has always been, divinely authoritative. To him no code of conduct or even scale of values can be formulated by human reason: all must of necessity, be based on divine

Revelation.⁶ Those who adhere to the Orthodox system of finance in Islam insist upon interest-free economy. In their opinion Islam will be shaken to its foundation if interest or *Riba* is allowed. Instead, they advocate, *Mudaraba* as the effective method for banking in Islam.

Since things have changed due to the astounding development of science and technology, the Muslim World is confronted, today, with new problems. Its social and economic life has undergone a great revolution and in consequence economic thought has taken a new direction and demands wholesale repeal of the *Riba* rules. Unless all obstacles in the way of capitalistic enterprise are removed, economic development is considered as impossible. The agitation for the removal of all restrictions on economic credit is gaining ground and Islam is in a state of gestation.

To an impartial eye the economic structure of society, today, is entirely based upon credit and without credit no progress, whatsoever, is possible. Credit is the crank-shaft of commerce and industry. Credit is the life-blood of business. The Muslim states are still in a developing stage. Though politically independent they are yet economically dependent. Credit is essentially required for their economic development, nay, even for their subsistence and survival. Islam is thrown into dismay because it has to make some effective reply to the challenges of the modern world.

In evolving a system of banking we have to take into consideration all these facts and the fact that the Muslims have to deal with the non-Muslims within their country and outside it. They can not keep themselves aloof. The achievements of science and technology have reduced this vast globe to a small house wherein even whispers could be heard from corner to corner, hence the need for cooperation between nation and nation, country and country. Then, are we to give ourselves to the ways of others? The remedy does not lie in a complete surrender, we have to evolve a system of our own without violating the fundamentals of Islam. Islamic law is based upon broad principles which admit of interpretation to accommodate our growing needs and if anything is left unaccommodated be had if anything is left unaccommodated then recourse may be had to the Rule of Necessity and Need.

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CHAPTER 13

RULE OF NECESSITY AND NEED

NECESSITY KNOWS NO LAW

‘Necessity permits prohibited things’¹ is the general maxim and according to al-Ghazzali all prohibited things become permissible by necessity.² There are numerous examples to illustrate this point. They include those legal excuses which exempt from legal duties, such as minority, lunacy, illness, duress, forgetfulness and ignorance.³ Other examples where necessity renders prohibited things permissible are: eating of the meat of a dead animal by the hungry, and drinking of wine by the thirsty or, according to some jurists, by the sick as a medicine.⁴

Islamic law is considerate enough to take notice of particular occasions where its severity is to be mitigated in order to provide facilities to those who are subject to hardship. We read in the Qur’an: God desireth for you ease; He desireth not hardship for you;⁵ He hath chosen you and

hath not laid upon you in religion any hardship;⁶ Which is further supported by the saying of the Prophet; 'Religion is facility. The most beloved religion to God is tolerant orthodoxy'.⁷

It is perhaps for this reason that al-Marwardi (Qadi Husayn) has described this rule as one of the four pillars supporting the structure of jurisprudence.⁸ 'Hardship begets facility,' is the essence of this rule. *Majalla* (Ottoman Civil Code) has enunciated many rules on this principle such as payment by instalments allowed to the debtor if he is in straitened circumstances. 'And if the debtor is in difficulty, grant him time till it is easy for him to pay'.⁹ is the Qur'anic verse. Likewise the period of hire is extended until the shore is reached if a boat is taken on hire for a certain period and the period expires while still on the journey.¹⁰ The most outstanding of all such examples is the transaction of *bai-bil-wafa* or redeemable sale which came into existence to meet the needs of heavily indebted people of Bukhara. This has been referred to in the *Majalla*: 'Need, whether of a public or private nature, is treated as necessity' The validity of sale subject to a right of redemption is of this nature. The inhabitants of Bukhara having fallen badly into debt, this procedure was put into operation in order to meet their need for it.¹¹

Fitzgerald has treated the rule of necessity as a source of law.¹² Necessity knows no law, is the common precept and

can be applied to cases of urgency. The mounted soldier awaiting battle is allowed to say his prayers in the saddle instead of dismounting.¹³ Fasting during the month of Ramadan is obligatory but its postponement is permitted while a Muslim is travelling.¹⁴ Similarly a starving Muslim may eat of forbidden things to save his life.¹⁵

LIMITATIONS

The meticulous adherence to law in certain cases turns into injury and is followed by serious consequences, so it is allowed under Islamic law to invoke the Rule of Necessity and Need on such occasions. But one has to make a distinction between necessity and need. By necessity it is usually meant something more pressing than need and which, if not fulfilled, will lead to serious results. Hunger, for instance, if not satisfied may result in death. Therefore, the Rule of Necessity and Need is not a free licence but subject to certain limitations which may best be explained by the Qur'anic verse: 'He hath forbidden you only carrion, and blood, and swine flesh and that which hath been immolated to (the name of) any other than God. But he who is driven by necessity, neither craving nor transgressing, it no sin for him.'¹⁶

Mark the words 'neither craving nor transgressing' which are interpreted by Tabari as having no vehement desire for eating what is forbidden nor intending to overstep

the limit by permitting oneself to eat what is forbidden when one can afford to refrain from it on account of what can be had of lawful things;¹⁷ and as a natural corollary says Razi, the sanction contained in this verse ceases to exist when the urgency exists no more.¹⁸

Necessity under Article 22 of the *Majalla*, is estimated by the extent thereof and so is the time limit. Whatever is permissible owing to some excuse ceases to be so with the disappearance of that excuse'.¹⁹ And this is quite in conformity with the principles of justice and equity.

Frankly, the determination of the extent and the time of the necessity and need, and whether it is need or necessity, depends, in individual cases, upon one's conscience and *taqwa* or fear of God which is the true measure of judgement of human actions, but in matters where the interests of community are involved these factors may be decided in the manner suggested by Ghazzali—*ijma* of the community for the fundamentals and *ijma* of the scholars for the matters of detail.²⁰

Here it may be mentioned that according to Ibn Qayyim what is prohibited as a preventive measure or *sadd al-Dharia* becomes permissible in order to satisfy the needs of society but what is forbidden purposely can not be permissible unless there be necessity for it. This distinction between need and necessity is to be observed in deciding cases.

It is generally presumed that the Rule of Necessity and Need has a limited scope and can not serve as a source of law but it is a wrong presumption because the rule is always there to meet the needs and necessity as and when they arise.

To be brief, divine law as expressed in the Qur'an and the *Sunna* of the Prophet, is implicit in it solutions for all the problems of life. Let us first examine whether *Mudaraba* is a solution for our problem.

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CHAPTER 14

MUDARABA

THE DEFINITION:

Mudaraba, according to jurists, is a contract whereby one gives his property to another to carry on business therewith and the profit to be shared between them according to the specified terms such as $\frac{1}{2}$ of the profit or $\frac{1}{2}$ and so on.¹ Here we have to point out that *Mudaraba* is generally considered a contract of partnership whereby both the partners share profit and loss equitably, but it is not so. The entire loss is always attributed to and deductible from the capital. *Mudaraib* or agent has nothing to lose except his labour² and therefore, Hanafi jurists do not count it as a real partnership.³

There is a marked difference between *Mudaraba* and other kinds of partnership. Whereas all other kinds of partnership may consist of two or more persons, *Mudaraba* consists of only two—one is the financier and the other his

agent. The financier invests his capital and the agent his skill. Whereas in other partnerships each partner is an agent of and for the other, there is no such case in *Mudaraba*.

Mudaraba, In its real sense, is *Muqarada*,⁴ derived from *qard* or loan granted to *Mudarib*, to do business with a view of earning profit, but the people of Iraq call it *Mudaraba*,⁵ derived from *darb* or traveling as *Mudarib* has to travel for the sake of business. Since this contract is based on *qard*, the jurists have been at pains to treat it more carefully, lest the profit earned through it, should amount to *Riba*.

RELATION BETWEEN THE PRINCIPAL AND AGENT, I.E. MUDARIB

In order that the lender may not enrich himself unjustifiably it has been held by the majority of jurists that he should neither participate in the work, nor ask the *Mudarib* to invest something of his own. The capital must be surrendered to the *Mudarib* so that he may handle it alone⁶ (without any interference, whatsoever from the lender or principal). Loss, if any should be assigned to the capital, the agent or *Mudarib* will not bear it. This implies that *Mudarib* should continue as an agent, neither invest anything of his own nor bear any material loss. More so because if he contributes to the capital, he will equally be a principal himself which can not be allowed.

Such being the case, an Islamic bank will not be able to advance loans to the concerns which have already invested capital of their own for, apart from the disputes that may arise as to the distribution of profit and the assignment of loss, it would be quite against the principle of *Mudaraba* for a *Mudarib* in such a case may claim to be a principal himself. One can not be both a principal and an agent at the same time, and in the same concern as it would result in a conflict of interest.⁷ Thus, a large number of applications for short time loans, which are generally required in the course of production by those who have already invested their capital, can not be entertained by an Islamic bank, though such loans are most welcome to a prudent banker

The principal, as specified above, has to surrender his capital to the *Mudarib* so that he may handle it freely.⁸ But how can the banks rely upon the *Mudarib* who is neither liable for the loss, nor has offered any tangible security for the loan? And the *Mudarib* who is an agent can not be expected to offer any security. Will it not then be risky for the banks to rely upon such *Mudarib*? In order to avoid the risk the bank will have to conduct the affairs and control the activities of *Mudarib* which will eventually amount to participating in the work and hence unlawful.⁹ Let us now, refer to the view of the famous four schools of prominent jurists. Rules which govern *Mudaraba* are.¹⁰

1. That the *Mudarib* is in the position of of a trustee

when he takes possession of the property (i.e. capital), and before he actually starts his work. This implies, that the property is held in trust for the owner and the *Mudarib* must take care of it and be prepared to return it if demanded by the owner but he (*Mudarib*) will not be responsible if such property is lost.

2. That the *Mudarib* assumes the position of an agent when he starts work. He represents his principal within the authority given to him. The principal is, therefore, responsible for such contracts of the agent as fall within this authority. The agent shall not be obliged to perform anything beyond this authority.
3. That if there is a profit the agent shall have a definite share in it as partner.
4. That if *Mudaraba* becomes void, the *Mudarib* or agent shall be considered an employee in that the whole profit or loss (as the case may be) shall fall to the share of the principal and the agent shall be entitled to remuneration according to the nature of work.
5. That the *Mudarib* shall be considered to have acted wrongfully if he violated the terms of the contract and in such case he will be liable for his wrongful act.

6. That in case the whole of profit is stipulated to be the share of *Mudarib*, the transaction will be that of a loan or *qard* and the *Mudarib* shall be entitled to profit and liable to loss. The *Mudarib* having used the loan for business shall have to repay it.
7. That if it is stipulated that the whole profit will fall to the share of the principal, this will be considered a contract where by the *Mudarib* is authorized to purchase certain goods without any remuneration for his services. Whatever is purchased shall be for the principal who shall bear all the expenses incurred in such transaction.

The essential pre-requisites of *Mudaraba* are offer and acceptance couched in terms that are definite such as 'take this property (i.e. capital) and act as a *Mudarib*.'

The terms of a valid contract of *Mudaraba* are:— ¹¹

1. That the capital should consist of cash such as minted gold and silver and not commodities (because their prices fluctuate which may lead to disputes between the parties). There is a conflict of opinion about their acceptance as capital.
2. That the capital should be known at the time of the contract so that no disputes arise between the parties.

3. That the capital should be determined and in possession of the principal so that he may be able to give it direct to the *Mudarib*.
4. That the capital should be made over to the *Mudarib* so that he may handle it alone: and if it is stipulated that the principal will participate in the work with agent, the contract will be void.
5. That the share of *Mudarib*, in the profit should be determinate and expressed in such terms as $\frac{1}{2}$ of the profit or $\frac{1}{3}$ and so on. The contract will be void if the share is expressed in such terms as £20 out of the profit because there is risk in it (may be the profit does not amount to this sum)
6. That it should be made a condition that the *Mudarib* shall receive his share out of the profit and not out of the capital.

With the exception of some minor differences the definition of *Mudaraba* and the rules governing it and also the condition of its validity are, more or less, the same under the four Schools. *Mudarib*, according to these views, is an agent to carry on business and partner in profit.

WHETHER MUDARABA IS PRACTICABLE

Mudaraba was in vogue in the *Jahiliyya* (pre-Islamic period) and Islam adopted it because of its good quality as it is instrumental in combining the skill of one person with

the capital of another.¹² The *Mudarib* being skilled person must be free to work and the principal has no right to have his hand in the work.¹³ He may not even control or supervise the work as it would amount to interference in the activities of *Mudarib* and vitiate the contract of *Mudaraba*, for *Mudarib* alone is to handle the Capital as he knows how best to transact business. Assuming that the Banks are allowed to control and supervise the work, how are they to meet the expenses required for such supervision? It will entail colossal expenditure as they will have to employ a number of advisers, engineers and experts. Here we refer to the processing of loan and the control exercised, over the borrower, by the World Bank.

From the extracts which we have given in chapter 8, it may be seen that, inspite of state guarantee for the loan, the World Bank conducts the whole transaction with the borrower from first to last till the loan is repaid. Though it maintains a fleet of experts and a team of engineers, yet is constrained to borrow technical experts from member governments, other international agencies or private firms.¹⁴ This is to show the magnitude of difficulties and the measure of expenses which the Bank has to incur. Is it, then possible for ordinary banks to encounter these difficulties and meet such expenses specially when they have to control a number of small and big concerns ? Will it be profitable to proceed on these lines ?

Conceding for a moment, that the banks can surmount all these difficulties and make profits by way of *Mudaraba*, the banks, then will be more inclined to make advances to the *Mudarib* alone. What about the needs of other businessmen and enterprisers who require short term commercial loans or producer credit ? Would the banks make interest-free loans to them ? It is suggested, here, by some of the thinkers that the banks may be made to advance such loans by the announcement of the Central Bank that they will not be allowed to make use of deposits by way of *Mudaraba* if 50% of such funds is not devoted to interest-free loans.¹⁵

But the applications for such loans will be numerous, each applicant trying to obtain interest-free loan for as long a period as possible. It is again a difficult situation for the banks. The Central Bank may come to their help and declare that priority be given to those who are first in point of time. This will not serve the purpose as applications may have been received at the same time by post or other means rendering it difficult to declare that a particular set of applicants are given preference. If it is so declared there will be a great protest against it and also injustice to those who have genuine and pressing needs. There can be no hard and fast rules in this connection as the needs differ from person to person and place to place. Besides, how can the inclination of the banks towards their *Mudaribs* be checked?

From among the applicants they will advance such loans to those who are working as their *Mudaribs* and the rest to go disappointed.

There are a number of other questions too: will the loans be supported by securities for *Mudarib* being an agent can not be expected to offer any security? Even if he offers any security it will be of no avail to the banker, for according to the rules of *Mudaraba*, loss will always be attributed to the principal, i. e. the banker and as such he can not fall back upon the security to recover the loss. Supposing that such securities are of some use to the banker, what will be the nature of these securities and how will they be charged in favour of the bankers?

Further, what about the expenses of the staff employed to administer interest-free loans? If these are properly answered, there are other questions with regard to consumer loans and the discounting of bills.

The importance of bills in inland as well as foreign trade can not be exaggerated. How are these bills to be discounted? It is often said that the banks, when they pay no interest or dividends, should not hesitate to cash such bills free of charge. And, in view of the fact that there will be a great rush upon the banks if the bills are cashed without any charge, it is proposed that only such bills should be cashed for which their drawer, drawee or the person who presents

them or all of them combined, have at least $\frac{1}{3}$ value of the bill in current deposits of the Bank.¹⁶ But this proposal does not appeal to reason because the banks can not be forced to cash the bills and because such bills are not inland or domestic bills alone but also foreign bills which can not be brought under this rule. If A, of London draws a time bill upon F, Bank of France, to be paid to B, of France and B, after having the acceptance of the drawee Bank, proceeds on a business tour to an Islamic country and presents the bill to C, Bank (of course an Islamic Bank) which is a correspondent of the drawee Bank. Then how can B, be expected to have $\frac{1}{3}$ value of the bill in the current deposits of C, Bank and for what ?

Mudaraba, is therefore, impracticable and also risky if the *Mudarib* turns out to be dishonest and of fraudulent disposition. The risk is more enhanced if he lands the bank into other encumbrances, for whatever the relations between him and the bank, to the outside world he virtually embraces the character of a partner.

According to Pollock such person may bind his firm by any of the following acts: ¹⁷

1. He may sell any goods or personal chattels of the firm:
2. He may purchase on account of the firm any goods

of a kind necessary for or usually employed in the business carried on by it:

3. He may receive payment of debts due to the firm, give receipts and releases for them:
4. He may engage servants for the partnership business, if this is in trade, that is, if the business is one which depends on the buying and selling of goods:
 - (a) He may make, accept and issue bills and other negotiable instruments in the name of the firm (a member of a non-trading partnership may bind the firm by negotiable instruments, but only in those cases where it is shown to be within the usual course to issue negotiable instruments, the burden of showing this being on the person attempting to make the firm liable):
 - (b) He may borrow money on the credit of the firm:
 - (c) He may, for the purpose, pledge any goods or personal chattels belonging to the firm.

For these and other reasons mentioned above, *Mudaraba* is of limited scope and risky for banking. Banks, even if they are nationalised, cannot work successfully under *Mudaraba*, for *Mudarib* being the skilled person must be

free to act within the authority, and as such, nobody, not even the state, can interfere in his activities. The capital as stated above, must be completely made over to him so that he may handle it alone. The principal is not allowed to participate with him in work, nor is the *Mudarib* or agent authorised to invest anything of his own so as to become the principal himself. *Mudarib*, as explained above, cannot be expected to furnish security for the capital made over to him. Even if he is made to furnish such security, it will be of no use to the principal, for according to the rules of *Mudariba*, the entire loss is attributed to the principal and he can not fall back upon the security to recover it.

Such being the case, is it possible for the Islamic Bank to rely upon such an agent or exercise control over the project for which loan is advanced when such control itself amounts to interference in the agent's activities with the result that the contract of *Mudaraba* becomes vitiated. Supposing that such control is possible will it be profitable to engage a fleet of experts and engineers to supervise the work which is not confined to a few big industries but extends over a large number of various small business concerns? Let us, therefore study the law of Islam relating to loan transactions and find out if there is nay other way of solving our problem.

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CHAPTER 15

ISLAMIC LAW RELATING TO LOAN TRANSACTIONS

THE TEXT

Here is the text of the Qur'an which deals with transactions involving future obligations:

'O ye who believe ! when ye deal one with another, in lending for a term named, reduce it to writing. Let a scribe write down faithfully as between the parties: let not the scribe refuse to write: as God has taught him, so let him write. Let him who incurs the liability dictate, but let him fear his Lord God, and not diminish aught of what he owes. If the party liable is mentally deficient, or weak, or unable himself to dictate, let his guardian dictate faithfully, and get two witnesses, out of your own men and if there are not two men, then a man and two women, such as ye choose, for witnesses should not refuse when they are called on (for evidence). Disdain not to reduce to writing (your contract)

for a future period, whether it be small or big: it is juster in the sight of God, more suitable as evidence, and more convenient to prevent doubts among yourselves, but if it be transaction which ye carry out on the spot among yourselves, there is no blame on you if ye reduce it not to writing. But take witnesses whenever ye make a commercial contract: and let neither scribe nor witness suffer harm. If ye do (such harm), it would be wickedness in you. So fear God; for it is God that teaches you. And God is well acquainted with all things.²¹

The first part of the text deals with transactions involving future payment, and the second part with transactions in which payment and delivery are made on the spot. As to the transactions of the first part written document is recommended while the transactions performed on the spot require no evidence in writing except oral witnesses and even these oral witnesses are dispensed with if the parties trust each other: Let the trustee (faithfully) discharge his trust, and let him fear his lord.

It has to be admitted that commercial morality is here taught on the highest plane and yet in the most practical manner. All such transactions are to be carried out as in the presence of God. The above verses while providing safeguards against disputes that may arise in the absence of document and witnesses, allow loan transactions for a

fixed time. Transactions involving advance payment such as *salam*⁷ (where the price is paid in advance for a determinate thing to be supplied in future) and even *bai* (sale of a determinate thing for the price to be paid in future) are covered by these verses.

It is well said by Ibn Abbas, the cousin of the Prophet and his Companion that while *riba* (interest or usury) is prohibited, *salam* which is, in fact, a loan for fixed period, is allowed.² He narrates that the inhabitants of Madina were dealing in dates on the basis of *salaf* or loan for fixed time and the Prophet, on his arrival at Madina, allowed such dealings provided the measure or weight of dates was known and the time for the performance of contract was fixed.³

The word *salaf* literally means a loan which draws forth no profit for the creditor.⁴ In its wide sense it includes loan for specified period i.e. short, intermediate and long-term loans. But if it is immediately to be paid it is called *qard*⁵ or loan payable on demand. This is in fact a particular kind of *salaf*.

The literal meaning of *qard* is 'to cut'. It is so called because the property is really cut off when it is given to the borrower.⁶ Loan advancing by way of *qard* is according to the saying of the Prophet, more pleasing to

God than alms - giving?⁷ Its legality is proved, beyond doubt, by the *ijma* or the consensus of jurists.⁸

It is narrated by Abu Rafi that the Prophet borrowed a young camel and, when other camels were presented to him, asked Abu Rafi to give away its similar or substitute to the person who had lent him the camel. Abu Rafi told the Prophet that he could not find among the presented camels a young one of the type of the borrowed camel as they were of the superior quality. The Prophet asked Abu Rafi to give away a superior one in return for the borrowed camel, for the best (among people) are those who repay (the debt) in the best possible manner.⁹

From the above it is proved that the loan, according to Islamic law, may consist of every thing that is valuable. Lending and borrowing are, indeed, unavoidable in this worldly life, and therefore, permissible in Islam. Had it not been permissible the Prophet would never have set an example of a borrower. But it has to be borne in mind that the loan whereby by something in excess is exacted becomes unlawful as it amounts to *riba*.¹⁰

The Prophet says that after a loan has been advanced the creditor must refrain from accepting even a present from the borrower unless exchange of such present was in practice between the borrower and the lender before the advancement of loan. Repayment of debt, in superior

quality, may be allowed provided there be no stipulation to this effect at the time of the contract.¹¹ Hence jurists see no harm if it is agreed between the parties that the debt will be paid off through cheques and draft or that it will be paid in some other country if it is in the interest of both the parties. Ibn Zubair, for instance, used to accept sums of money from the inhabitants of Makkah to be paid in Iraq through draft drawn upon his brother Musab who lived in Iraq. To this Ibn Abbas and Ali, the Companions and cousins of the Prophet, did not take any objection.¹²

For further elucidation, we quote from the Maliki school according to which *qard* is a loan of something valuable granted only as a favour and not by way of *ariyya* (aid) or *hiba* (gift) but to recover it in the form in which it was granted. The word 'valuable' is purposely used to exclude from the definition of *qard*, that which is not valuable, and the word 'favour' to show that the profit is for the borrower alone and not for the lender.¹³ Under this definition, *qard* may consist of every thing that is valuable, be it merchandise, animal or similars of weight and measure but according to the Hanafi school it should consist of similars of weight and measure.¹⁴ This is not reasonable as the Prophet himself had borrowed an animal. The shafii school describes *qard* as *hasan* or beautiful.¹⁵ Which is referred to in the Qur'an: 'Who is he that will loan to God a beautiful loan, *qardan* hasan, which God will double into his credit and multiply

many times ? it is God that giveth (you) want or plenty and to him shall be your return'.¹⁶ According to the Hanbali school it is virtually a transfer of ownership in property so as to recover its similar or substitute.¹⁷

In view of all these definitions and the practice of the Prophet it may be said that *qard* is a kind of loan advanced for the benefit of the borrower. It may consist of every thing that is valuable and its similar or substitute becomes payable immediately or on demand. It should not fetch any excess to the lender because it amounts to *riba* which is strictly forbidden.

To sum up, loan under Islamic law, may be classified into *salaf* and *qard*, the former being for a fixed time and the latter on demand. And every loan that draws forth or stipulates profit is unlawful. Let us therefore find out why it is unlawful. For this purpose we shall have to investigate the meaning of *riba*.

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CHAPTER 16

MEANING OF *RIBA*

THE WORD *RIBA*

The word *riba* literally means 'increase' or excess is used in this sense in the Qur'anic verses: 'And thou (Mohammad) seest the earth barren, but when we send down water thereon, it doth thrill and swell (*rabat*) and put forth every lively kind of (growth)'¹ Because of a nation being more numerous (*arba*) than other nation;² But in the terminology of the *Jahiliyya* (pre Islamic period) it is an excess charged over the principal to grant extensions for the payment of debt. It is therefore, called *riba nasia* or excess charged for delayed payments. This is 'strictly prohibited in Islam as it is considered unjustified enrichment and monetary advantage without a countervalue.'³ Islam permits trade and forbids *riba*.⁴

As an excess over the principal is *riba*, it covers usury and interest both. Therefore, it can not be contended that

riba applies to usury or lending of money at an exorbitant rate which is cruel, while interest at a low rate is allowed. nor can there be any distinction between the interest for productive purposes and the interest for non productive purposes

KINDS OF RIBA

There are two kind of *riba*; (1) *nasia* and (2) *fadal*.⁵ the word *nasia* means, delay granted to the debtor.⁶ it is used in this sense because the creditor, so to say, overlooks the delay in payment of the debt in consideration of something in excess over the principal. The word *fadal* signifies the excess charged in the exchange or sale of things of homogenous nature or similars of the same species.

Considered from the legal point of view there is a marked difference between the two. While *nasia* relates to the excess charged in loan transactions, *fadal* relates to excess charged in sale transactions. While *nasia* is forbidden by the clear text of the Qur'an, *fadal* is prohibited by the *sunna* or Traditions of the Prophet. If we probe deep, it becomes evident that *nasia* was in vogue in the *Jahiliyya* and is forbidden in Islam because of its evil and cruel nature. Whereas *fadal* is prohibited by the Prophet as a precautionary and preventive measure lest it should lead to *nasia*, and what is prohibited as a preventive measure is not unlawful in itself.⁷

On this account ibn Qayyim distinguishes *riba nasia* from *riba fadal*. According to him the former is *Jali* or express and the latter *Khafi* or implied.⁸ In support of his statement he relies on a saying of the Prophet as narrated by ibn Abbas according to which *riba* is in *nasia*⁹ i. e. excess charged for delayed payment which was prevalent in the *Jahiliyya*. This is further strengthened by the verdict of Imam Ahmed who upon being asked as to *riba* said that it consists in an excess over the principal charged to grant an extension for the payment of debt.¹⁰

For example, an amount is advanced as a loan for a fixed time, then the creditor continues adding to it for each delay in payment of debt to such an extent, that the whole property of the debtor is consumed by a small amount of loan. And often it so happened that the debtor himself, being afraid of the cruel treatment for the delay in payment of the debt, went on extending time, on a promise to the creditor of something more towards interest which ultimately resulted in his complete ruin. This is, indeed destructive to society and, therefore, forbidden.¹¹ The selfish grasping greed of usury against those in need or distress is condemned by the Qur'an in the strongest possible terms and charity encouraged.

‘Those who (in charity) spend of their goods by night and by day, in secret and in public, have their reward with their lord. On them shall be no fear, nor shall they grieve.

Those who devour usury will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say: 'Trade is like usury;' but God hath permitted trade and forbidden usury. Those who after receiving direction from their lord desist, shall be pardoned for the past, their case is for God (to judge); but those who repeat (the offence) are companions of the fire: they will abide therein (for ever).

'God will deprive usury of all blessing, but will give increase for deeds of charity; for He loveth not creatures ungrateful and wicked.

'Those who believe, and do deeds of righteousness and establish regular prayers and regular charity, will have their reward with their Lord: on them shall be no fear, nor shall they grieve.

'O ye who believe! fear God and give up what remains of your demand for usury, if ye are indeed believers.

'If ye do it not, take notice of war from God and His Apostle: but if ye turn back, ye shall have your capital sums. Deal not unjustly and ye shall not be dealt with unjustly;

'If the debtor is in a difficulty, grant him time till it is easy for him to repay, but if ye remit it by way of charity that is best for you if ye only knew;

‘And fear the Day when ye shall be brought back to God. Then shall every soul be paid what it earned and none shall be dealt with unjustly.’¹²

The sharp contrast between charity and usury has been depicted in a most touching manner and in the last four verses creditors have been asked to give up their claims based upon the past usury. Instead of exacting excess it has been ordained that the creditors should grant the debtors, if they are in distress, time for the payment of principal and even write off the debt by way of charity if it is necessary.

What is intended by these verses is to wipe out the evils of the *Jahiliyya* pertaining to the system of *riba nasia*. The Prophet has, therefore, expressed his curse upon not only the parties to such transaction but also upon the scribe on the document and witnesses thereof.¹³

Ibn Qayyim draws a sharp line of distinction between what is forbidden purposely and that which is prohibited by way of preventive measures in order to prove that *riba fadal* is preventive measure he quotes the saying of the Prophet as narrated by Abu Saeed al-Khudri; ‘Do not sell one dirham (coin) for two because I fear *rima (riba)* on your part,’¹⁴ the words ‘I fear’ are clear proof of the fact that the Prophet prohibited this sort of sale because he feared that it might lead to *riba nasia*.

This is the chief cause why excess in the exchange or sale of similars of the same species has been prohibited. The prohibition relates to gold, silver, wheat, barley, dates and salt. Gold, for instance, cannot be exchanged for gold unless there be equality in quantity and immediate delivery. If they differ in species such as wheat for barley then equality in quantity is not insisted upon but there must be immediate delivery of the both.

Jurists agree on this point that *riba* or excess is prohibited in the exchange of aforesaid six commodities and differ as to application of *riba* rules - equality in quantity and immediate delivery - to other than these six. Some of the jurists are of the opinion that the prohibition is confined to the above six commodities only. While others maintain that it applies to all other commodities which are deemed to possess the same characteristics. Those who agree on the extension of prohibition to other than six commodities differ in point of effective cause or 'illa' of such prohibition. In Shafii and Hanbali law *riba* rules are applied to the barter of all foodstuffs, in Malki law only foodstuffs which can be stored or preserved. While in Hanafi law they are extended to all fungible commodities normally sold by weight and measure.¹⁵

Ibn Qayyim assert that *riba fadal* being prohibited by way of preventive measures i. e. *sadd-al-dharai* becomes permissible to meet the needs of community. *Al-Araya*¹⁶ (sale of fresh and ripe dates for dry dates) for instance was declared by the Prophet as lawful in view of the desire of the people for fresh dates though such sale is the exchange of similars of the same species. This is the most outstanding example where *riba fadal* was made permissible.

Ibn Qayyim has cited other cases to substantiate his statement, for example, a person who asks a woman in marriage can have a look at her though he is, otherwise, forbidden to do so. Similarly there is no blame on ladies if they appear before their physicians or witnesses, the formality of a screen in such cases is dispensed with to provide for the needs of society.¹⁷

This sort of permissibility, he says, is required for the ends of justice because the needs of society can not be satisfied without it or else one has to resort to legal fictions. There are jurists who, in order to avoid the the rigour of law, invent their own way of seeking permissibility by means of legal fiction. A person, for example, sells to another an article worth twenty dirham), plural of dirham, a (coin) for forty and adds to this some other sixty, making in all a hundred dirham for the borrower, though he received only eighty, Ibn Qayyim denounces this way of dealings.

To him what is forbidden by way of preventive measure becomes permissible in view of the public needs, but that which is positively prohibited can not become permissible unless there is necessity for it. And according to the expert in banking, Islamic Banks may be formed and run on this principal as explained later under chapter.¹⁹

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CHAPTER 17

ISLAMIC BANK

FORMATION

There is no statutory definition of a bank completely general. It may be a financial institution operated by an individual as a sole proprietor, or it may be a partnership or a corporation, or other type of association.¹

According to Islamic law partnership are of various kind but the one best suited to the purposes of banking is *shirkat-ul- inan* or partnership whereby two or more persons join in business, each of them being an agent and for the other. The capital is not necessarily to be shared equally and the profit to be distributed according to the terms agreed upon between them. under the principal of what is not forbidden is permissible.² An Islamic bank may be a company, an association or a concern owned by an individual.

Partnership then, must be distinguished from a company. The main practical difference between a company and a partnership is this that the formation and existence of a partnership depends upon the mutual trust in and personal relationship of, the members to each other, whereas the formation and existence of a company does not depend to any extent on this; further, whilst in partnership every member is entitled to take part in the management of a business unless he bargains away his right, in a company the management is left to specified officers.³

FUNCTIONS

The functions of a modern bank are many, some of them are enumerated under chapter 1. We have to see that the chief function of a modern commercial bank are performed by Islamic banks. The chief function of a banker may be described as receiving money from his customers, and to collect instruments representing money on behalf of his customers on the understanding that he will refund all moneys received or collected, either on demand or at some definite date agreed upon between him and his customers. Islamic bank have no difficulty in performing this function. But there are other important functions too. A banker is also

- (a) a lender of money
- (b) a discounter of bills and promissory notes.

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- (c) an issue of draft, letter, of credit and traveller's cheques, an acceptor on behalf of his customers of bills drawn on the authority of letters of credit.⁴

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CHAPTER 18

LOAN AND SECURITIES

LENDING

How is an Islamic bank to perform its function of a lender on profitable lines? Loans as we have seen in chapter 15 are of two kinds, *salafi* i. e. loan for a fixed time which may include short, immediate and long-terms loans, and *qard* i. e. loan recoverable immediately or on demand. Islamic bank may make all sorts of advances as described in chapter 4. It may accept time and demand deposits from the public which are, in fact, loan to the bank.

Bankers borrow to lend again and every lender must have a lively regard to the chances of repayment since no lender from the earliest times has been content to rely upon mere word of borrower to pay, but has demanded some tangible security to which he could have recourse in the event of failure by the borrower to fulfil his obligation. Islam is not a repellant to this idea and has laid down some broad

principales in this regard. We come across in the Qur'an: If ye are on a journey, and cannot find a scribe, *rahn maqbuda* or a pledge with possession (may serve the purpose).¹

PLEDGE

The word *rahn* stands for a pledge or security. In its real sense *rahn* means 'to last' or to continue² and according to jurists it signifies 'pledge.' Every soul is in pledge or *rahina* for its deeds³ is the Qur'anic verse and the soul of a believer is *marhuna* or pledged for the debt until it is paid off, is the saying of the Prophet.⁴ According to Islamic law pledge is a security for the satisfaction of debt if the debtor failed to repay it⁵ and whatever validly forms the subject of sale may be given as a security. It is narrated by Aysha, the wife of the Prophet, that the Prophet purchased for his family, food from a Jew, against the pledge of his breast plate.⁶ And this is the convincing proof of the fact that: (1) a pledge is permissible of such property as is valuable, (2) it makes no difference that a person is on journey or at home (3) the transaction of this nature can take place even between a Muslim and non-Muslim.

NATURE OF PLEDGE

According to Abu Hanifa pledge implies an encumbrance or charge (on property so pledged) to the extent of loan.⁷ If a cloth for instance, of the value of 10 drahim, (plural of

dirham, a coin) is pledged for 10 drahim, the pledgee will have no claim against the pledger in case it is lost while in possession of the pledgee. But he will look to the pledger for the payment of the remaining part of the debt say, 5 drahim if the cloth were of the value of 5 drahim and shall pay to the pledger or hold in trust for him the excess if the cloth were of the value that exceeds the amount of loan.

According to Shafii, security is but a trust⁸ in the hands of the pledgee and as such whole of the debt remains payable by the pledger if the security be lost while in possession of the pledgee. He relies upon a saying of the Prophet that pledge can not be foreclosed, it is from the pledger and for him is its *ghunm* or accession and upon him is its *ghurm* or loss.⁹ It is further contended by Shafii that possession only of the security passes to the pledgee while its ownership remain with the pledger who may redeem it. Pledger as the owner is entitled to its accession and liable for its loss. Pledgee being a trustee can not be held responsible for the loss of security and therefore, can recover, from the pledger what has been lent to him. Consequently it becomes immaterial whether or not the security exceeds the amount of debt.

The argument of Abu Hanifa is based upon the saying of the Prophet as narrated by Anas, that the 'pledge is to cover what it is for'¹⁰ that is to cover the debt and therefore

security remains bound to the extent of debt as specified above. Further the words of the Prophet 'Pledge can not be fore closed' do not convey that security is a trust in the hand of the pledgee. The Prophet intended by these words that the pledge should remain redeemable and not to be appropriated wrongfully as was the practice in those days. The words *ghunm* and *ghurm* are not the word of the Prophet but are added by the narrator Ibn - al- Musaib.¹¹ Assuming that they are the words of the Prophet, they cannot be interpreted in the manner Shafii has interpreted them¹² because the word *ghurm* has been used in the Qur'an in the sense of debt or that which is payable 'verily the torment thereof is a debt payable (*gharama*)'¹³ Alms are for the poor and needy, and those employed to administer the (funds); for those whose hearts have been (recently) reconciled (to truth); for those in bondage and in debt (*gharimin*).¹⁴ So the word *gharm* does not mean loss to be sustained by the pledger but simply refers to the debt payable by him .

We have tried to explain the view point of the great jurists in order to clarify the nature of pledge under Islamic law. The pledge or security is in fact for the satisfaction of debt and hence the security is encumbered to the extent of the debt. The view of Abu Hanifa seems to be correct as it corroborates the view held by the Companions of the Prophet and their successors or *tabain*.¹⁵

When the duration of pledge expires, and the debt becomes payable, the pledgee can apply to the court to have the pledge sold and the debt satisfied out of the sale proceeds.¹⁶ To avoid this trouble and expenses the banker may have an irrevocable power of attorney to sell it on behalf of the pledger.

WHO IS TO DERIVE BENEFIT FROM A PLEDGE

There is great controversy as to who should derive benefit from a pledge or security. According to the Maliki school pledger is entitled to benefit by the pledge and its accession. But it is also possible for the pledgee to have such benefit provided (a) that the loan for which security is given is not of the nature of *qard* but has resulted from a sale transaction (e, g a person sells a piece of land or something else to another for a price to be paid within a fixed time and receives from the purchaser something as security for the price which is considered, here, as a loan) (b) that the benefit is stipulated, at the time of contract, for the pledgee (c) that the period of such benefit is specified.¹⁷

According to the Shafii school it is the right of the pledger to derive benefits from the security as he is the owner of it. The security would no doubt, remain in the possession of the pledgee except for the period when it is made use of by the pledger. It is lawful for the pledger to benefit by his property without the permission of the

pledgee, particularly so when such property is not reduced in value owing to its use. But if it is depreciated by its use it becomes unlawful for the pledger to use it without the permission of the pledgee.¹⁸

According to the Hanafi school it is by no means permissible for the pledger to benefit from security except with the permission of the pledgee. The pledger is not authorised to give such property in *ariyya* (aid) or *ijara* (lease),¹⁹ nor can he use it for himself. But there is a difference of opinion as to the use of such property by the pledgee. Some of the Hanafi jurists hold that it is not at all permissible for the pledgee to benefit from the pledge even with the permission of the pledger, for it amounts to *riba* but the majority of them maintain that the benefit may be derived by the pledgee with the permission of the pledger provided it is not so stipulated at the time of contract.

According to the Hanbali school security, if consisted of an object which needs maintenance such as animal the pledgee can benefit by it for what he spends towards its maintenance. The permission of the pledger is not needed in this case. But if the security consists of an object which does not require maintenance, then the permission of the pledger is needed to derive benefit by it. In case the security is for the satisfaction of a loan of the type of *qard* no such permission will give the right of deriving benefit because in

that case it amounts to *riba*. Likewise it is not lawful for the pledger to make use of security without the permission of the pledgee, but if the parties do not agree to the use of security it will remain without yielding income and also deteriorate and waste away. Whereas such waste is forbidden by the Prophet.²⁰

On an analysis of the above arguments we come to the conclusion that the difference of opinion is due to the fact that some of the jurists attach more importance to the possession of the pledgee while other lay greater stress upon the ownership of the pledger. It is said that permission is necessary to derive benefit, while in certain cases it is not, and again no permission is of any avail when the security is for loan of the nature of *qard*. It is in short a medley and a jumble of conflicting views.

In trying to solve this problem we come across a saying of the Prophet narrated by Abu Huraira, that the pledge (if animal) can be used for riding and its milk consumed in return for what is spent (on it) and its maintenance is on him who rides it and consumes its milk;²¹ This naturally refers to the pledgee as he is in possession of the pledge. This is further supported by the saying of the Prophet as narrated by Hashim according to which the fodder of the pledged animal is upon the pledgee and he can, in return, ride it and consume its milk for who derives such benefits is liable to

bear the expenses for feeding the animal.²² Here it becomes clear that pledgee is the rightful man to benefit by the security as it is in his possession and he has to maintain it. No permission, whatever, of the pledger is required in this regard.

The benefit is in return for the expenditure on maintenance. Some of the jurists say that the benefit should be in proportion to the expenditure otherwise it will amount to *riba*.²³ This argument is not tenable because it is not proved that Qur'anic verses forbidding *riba* were revealed after the above saying of the Prophet so as to apply to this case. Assuming that they were revealed after it, equality in quantity according to the *riba* rules, has to be observed in the exchange of similars of the same species and not in this case.

On this analogy, the islamic bank as a pledgee may derive benefit by a security in return for its service in maintenance of it. A house, for instance, requires maintenance and the bank can benefit by it on the above principal or charged the pledger for its services or even take it on lease and give it to someone for something more.

LIEN

Apart from pledge, the Islamic bank has the right of lien i. e. right to retain the property belonging to another until

a debt due from the latter is paid. This is called a possessory lien, which may be permissible under Islamic law on the analogy of seller who has been invested with a right to retain the property sold by him, in his possession until its price is paid to him.

MORTGAGE

Mortgage has no place in Islamic law as interest only in the property is transferred to the Mortgagee and not possession. Now we turn to discounting which is one of the chief functions of the commercial banks.

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CHAPTER 19

DISCOUNTING

THE DEFINITION

The word discount literally means an abatement or deduction from the amount or from the gross reckoning of anything. In its commercial sense it is a deduction made for payment before it is due, or for prompt payment, of a bill or account: any deduction or abatement from the normal value or price.¹ It is aptly described as the purchase and sale of commercial paper.² When a banker discounts a bill which stands for monetary value, he buys it outright for a sum less than its face value and, in other words, he purchases it at its present worth. Discount is, in fact, the difference between the face value of the bill and its present worth or value. In this transaction face value of the bill is exchanged for its present value. It is, thus, a sale of two monetary values. Discount transactions are, therefore, sale transactions.

One who presents the bill to be cashed by the banker has to accept something less than its face value and the excess earned by the banker is, no doubt, *riba*, but it is the *riba* in connection with a sale transaction and, therefore, *riba fadal* which according to Ibn Qayyim becomes permissible in view of the public needs as specified in Chapter. 16

Relying on the finding of Ibn Qayyim, the experts in banking assert that discounting being a sale transaction cannot fall under the definition of *riba* of the type of *nasia* which is expressly prohibited by the text of the Qur'an. Further, they refer to the case of *araya* (sale of fresh dates for dry dates) which was declared lawful by the Prophet himself in view of the desire of the people for fresh dates though such sale is the exchange of the similars of the same species prohibited by him as a preventive measure.

On this analogy, they argue that the exchange of monetary values as represented by gold and silver, must be allowed, for what holds good in the case of dates must also be valid, on the same ground, (i. e. needs of the people) in case of similars of the same species such as gold and silver which stand for monetary values. In this way they hold as permissible the exchange of the face value of the bill for its current value and say that the credit may be supplied by Islamic banks through the medium of discounting the bills which are none other than monetary values. Further, they refer to the word

nasia hich means 'delay granted to the debtor' and point out that *illat al Hukm* or the reason why *riba* was forbidden, lies in *nasia* as the delay was granted to the debtor' in return for some in or ease in the amount loaned out to him: and as remarked by Ibn Qayyim (*Ilam*, Vol. 2. P.266) it afforded an opportunity to the creditor to go on increasing his amount till a sum of one hundred was increased to thousands with the result that the debtor was completely ruined. This, they say, does not happen in discounting. Non we have to explain what the bills of exchange are for they play an important part in discounting.

BILLS OF EXCHANGE

The bills of exchange are negotiable instruments. Negotiability is that character of negotiable instruments which allows them to pass, usually by mere delivery, free from the equities; free from any defect arising from fraud or lack of title which would vitiate the transfer of any other kind of property, so as to pass the ownership to the instruments.³ And a person taking such instrument in a good faith and for value and without notice of defect of title, gets an indefeasible title against all the world.⁴ A bills of exchange is, therefore, a property of highest order.

Credit may be supplied to commerce and industry through the medium of discounting these bills. Property of every sort, provided it is not prohibited under Islamic law, may be

pledged and the accompanying bills discounted in order to secure the credit of the bank. Suppose A is in need of the bank credit. He will pledge his property with the bank and the bank would ask him to submit a promissary note with a memorandum, setting out the purpose of the deposit i. e., security. The bank will then discount the bill or promissory note and, thereby, create a demand deposit in his favour, for something less than the face value of the bill.

This is generally the procedure for issuing credit against all sorts of securities whether movable or immovable. So far as movable property is concerned it may be divided into two types, denoting whether the property is in actual possession, such as a book, or whether it is property not possessed physically but in the form of right or an interest in something of value. The former type of property is described as a 'chose in possession' (a chose being a French word meaning a thing) and includes all movable property that is in a material form. If, however, the property does not exist in material shape but is a right — valuable right that can be enforced in a court of law — then it is a 'chose in action'.

CHOSSES IN ACTION AS PROPERTY IN POSSESSION

If one has a ton of orange in one's warehouse he has chose in possession, but if the orange were in course of

shipment, unloaded on a dock or in a shipping company's warehouse and a documents is held showing the right to claim the oranges (e. g, bill of lading, dock warrant, etc.) that right evidenced by the document would be a chose in action. Further examples of a chose in action are debts, shares in a companies, Insurance policies, etc.

In nearly every case there will be some document or evidence in writing to prove the right and the document itself as representative of the right or claim, has come to be referred to as the chose in action. The commonest forms of choses in action in commercial use could be grouped under the heading 'Document of Title' since they operate as evidence of the right of some person to money or goods not in that person's actual physical possession.

The document of title is the main proof of ownership and, as it is the means or instrument of obtaining or establishing ownership, it is called as instrument. Each instrument refer to a certain property i. e, chose in action. According to Salmond' a chose in action is a proprietary right in personam and all proprietary rights (including such objects of right as are identified with the rights themselves) are treated as chose in possession.⁶ In its origin a chose in possession was anything or right which was accompanied by the possession; while a chose in action was anything or right of which the claimant had no possession but which he

must obtain, if need be, by way of action at law. The importance attached to possession is lost sight of. Originally shares and annuities would probably have been classed as things in possession but they are now things in action.⁷

A chose in action is, thus, a chose in possession and the document representing it has come to mean a thing and property in itself. Such documents, if offered as securities may be acceptable to Islamic banks. A pledge of the document of title to goods shall be deemed to be a pledge of the goods (Sect. 3 of the Factors Act 1889). The example of such documents may be a share certificate which represents the share, a bill of lading which represents the goods and such others. These documents are readily marketable and easily transferable as the goods themselves.

Now it remains to be seen whether an Islamic bank is allowed to deal in interest-bearing securities. The interest or profit which the securities bear is either pre-determined or post-determined. If it is pre-determined the security will not be acceptable, for it is unjustified enrichment. Islamic law does not tolerate any profit which is stipulated at the time of contract because apart from being a monetary advantage without a counter value, it is risky in that the profit may not, at all, be realized or, even if realized, it may be less than the stipulated amount. Besides, capital alone is

not the producing factor as there are other factors too, for example, land and labour and particularly the labour which contributes to the production of wealth. Capital itself has no producing power unless it is combined with other factors. Therefore the share of capital can not be fixed before hand and, indeed, it would be unfair to do so. And as such Islam is against pre-determination of profit unless it is actually realized. Instead of fixing a percentage at the very outset, it may be fixed out of the profit to be earned and this would be in consonance with the spirit of Islamic law which is permeated by religious and ethical considerations; each institution transaction or obligation is measured by the standards of religious and moral rules such as the prohibition of interest, the prohibition of uncertainty, the concern for the equality of the two parties, the concern for the just mean or average (*mithl*).⁸

Such being the case securities which bear pre-determined profit can not be acceptable to the Islamic bank but if the unlawful element i. e. interested connected with them is discarded, they may be acceptable. The unlawful element not being in the nature of securities but only attached to them, may be separated from them in that it is not reckoned with and the banks do not take it into consideration in their dealings. Islamic law allows to deal in things whose impurity is separable and is, really, separated.⁹

LEGAL FICTION

To some it would appear that the argument of the expert in banking is based upon legal fiction but they refute it and say that they have tried, in all sincerity, to interpret Islamic law on the basis of analogy and to satisfy the needs of society as it exists now. And according to them even legal fictions are not objectionable if the intention is to provide facilities to the community and to relax hardships.¹⁰

They stress again that discounting is a sale transaction and that there is a marked difference between discounting and a loan transaction. Whereas in the loan transaction there is every possibility of its being extended and converted into compound interest to the complete destruction of the debtor as was customary in the *Jahiliyya*, it is not so in discounting which decides the matter finally. This kind of finality is the characteristic feature of sale transactions and beneficial to both the parties. Conceding for a moment that discounting is a loan transaction even so it may be permissible under Islamic law when faced with necessity and according to the Article 32 of The Majallah (Ottoman Civil Code) the need of private or public nature is treated as necessity to sanction certain transactions for which people are in need in their economic life. Besides there is the analogy of *araya* to sanction it. This is the sum and substance of their argument.

But discounting is yet suspected of *riba*. What may be

suggested at this juncture is to reduce the discount to service charges of the bankers so that discounting is cleared of the suspicion. The banker, in this way, will have no profit except service charges to compensate him for the expenditure which he has to incur in supplying credit to the borrowers. The loan that draws forth or stipulates profit is *riba* as said by the Prophet but services charges are not profit and the Islamic bank may collect them from the borrowers separately or deduct straightaway from the amount payable to them. Such realization of service charges can not be called deduction from the face value of the bills which is their full value, hence it may be lawful for Islamic bank to supply credit through discounting the bills against their service charges. The central Bank shall, after taking into consideration all the relevent facts, fix a certain percentage as limit for such charges so that the banks do not overstep it.

In this case, there being no profit for Islamic banks, whatever they lawfully earn, through other lawful functions, shall constitute the profit which they may share and distribute among the depositors. So far as the distribution of profit is concerned it may be noted that Islamic law, as already stated, does not tolerate any profit which is stipulated at the time of contract (i. e, predetermined profit) because apart from being *riba* it is risky in that it may not at all be realized or, even realized, it may be less than the stipulated

amount. Under the circumstances the bank may invite capital by offering the percentage of the profit to be earned.

Here it may be said that there should be no service charges whatever, but it will be unfair to the banks and they may not be able to carry on their business. Service charges, while they give to the banks their due, are deterrent against the violent rush and irresponsible demands which the loan seekers will make upon them. Such charges may be dispensed with, if the State instead of resorting to nationalization (disliked by Islam) participates in the management of the bank by holding a controlling share (i. e, subscribing to their share capital in the amount of at least 51%).

Thus it may have a 'say' in their affair and contribute to their safety by alleviating the burden of administration and also by determining the loanable amount and priorities. Banks whose share capital is fully subscribed may increase it to the extent required by the State. *Mudaraba* being unworkable, interest-free loans will have to be advanced against securities and likewise bills paid without discount. The rest of the procedure will be the same as specified above.

The Islamic State needs a Central Bank to control the credit and currency and to act as a fiscal agent to the state, besides its position of the bankers' bank.

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CHAPTER 20

CENTRAL BANK OF THE MUSLIM STATE

BAIT-AL-MAL, THE 'FISCUS' OR 'TREASURY' OF THE MUSLIM STATE

Bait-al-Mal is often spoken of as the central bank of the Muslim state but it is entirely concerned with the public finance, its collection and expenditure. For further elucidation, the revenues of the State were collected under the following heads: ¹

1. The *Sadaqah* or *Zakat* revenue.
2. The *fay* revenues such as *jizia* and *kharaj*.
3. The booty revenue.
4. Property lost and found.

Zakat is an obligatory tax levied by an Islamic State on the members of the Muslim community. It is leviable not only upon surplus money but also on cattle, articles of trade and produce of soil. *Jazia* is the poll tax and *kharaj* is the land

tax. In almost all these taxes there is a share for the poor and needy and according to Mawardi the expenditure falls into two main categories.²

- (i) Claims in regard to which the liability of the Treasury is absolute. Such claims are either for services rendered to the State or for expenditure which is a specific obligation upon the State e.g. the duty to maintain the prisoners. The satisfaction of such claims is the first obligation upon the Treasury.
- (ii) Claims in regard to which the Treasury's liability is dependent upon the existence of the necessary fund and the satisfaction of all claim in the previous category. Hence the expenditure involved is for the purpose of the public welfare e. g. construction of roads etc.

The above are the main functions of *Bait-al-Mal*. This shows that *Bait-al-Mal* is not a Central Bank in the modern sense of the term.³ A Central Bank in its modern sense is chiefly the machinery employed to control credit and to act as the Bankers' Bank.

CENTRAL BANK

Each Muslim State, therefore, shall have to establish a Central Bank to act as its fiscal agent and the custodian of

treasury funds. It will control the credit by acting on the system of special deposit as introduced by the Bank of England, (but these deposits will not earn any interest for the depositor banks) and alternation in the reserve ratios of member banks. Besides note issue and control of currency it will act as the depository of the banks and the lender of last resort. In the capacity of an Apex Bank for the Banking system, it may perform all the functions of modern Central Bank.

As a fiscal agent and representative for the Muslim State it may be allowed to have interest transactions with non-Muslim States on the analogy of the Caliph Umar's orders whereby custom duties were levied upon the articles of trade of the non-Muslim neighbouring states in reprisal.⁴ It is of significance to note that the introduction of custom duties and tolls owes its origin to the fact that the neighbouring countries with which the Islamic state had commercial dealing persisted in levying the duties on the articles of trade of the Muslim traders. When Abu Musa Ashari reported the fact to the Caliph Umar, he ordered that as reciprocal measure the *hārbis* (persons belonging to non-Muslim states) should be charged the same rate that was being collected from the Muslims, i. e. 10%.⁵ Thus, the interest earned by the Muslim State, according to Siddiqui, is not *riba* but the amount recovered in retaliation.

This can not be an example for banks other than the Central Bank which represents the State. All other banks, if they earn any interest on their deposits or other accounts with foreign correspondents or banks must have it in reserve to be given to the poor and needy to save them from starvation. The Central Bank shall keep an account of this amount and, if necessary, hold it as its own reserve for charitable purposes. Let us dwell awhile on the form and features of Muslim world bank.

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CHAPTER 21

MUSLIM WORLD BANK

As the Muslim countries are in a developing state we need urgently a financial institution of the type of the World Bank, as given under Chapter 8, to render monetary aid to the development of their resources. The pattern of the above world bank may be adopted with such adjustments as suit our aims and objects.

As a first step in this direction the Muslim World Bank should take the form of an investment institution, represented by all Muslim countries on its Board of Directors who shall elect a full time president from among themselves. The president in his turn shall form an Executive Council composed of the representatives whose countries subscribe the largest capital and pay it in foreign exchange. The capital of the Bank is, therefore, to be subscribed in proportion to the direct revenue which a Muslim country receives in the form of foreign exchange. Thus foreign exchange difficulties may be solved for the present.

By 'foreign exchanges' we think of a system by which the obligations arising out of commerce and other international dealings are discharged. It is in fact a mechanism by which the money of one country is converted, for this purpose, into the money of another country. Easy convertibility of money and its transferability are, therefore, chief points to be considered.

To attain this object, we shall have to take further steps as our Bank develops. The par values of currencies of all the Muslim countries shall have to be fixed in terms of gold and be linked to the Dinar as the standard unit of the Islamic monetary union. This will be a sort of Dinar area similar to that of Sterling and Dollar areas. And free convertibility and free transferability of money may be established within this area to promote trade and industry between the members, with Dinar as their standard monetary units. It may be quoted as fixed or fluctuating unit whichever suits our purpose in relation to the currencies of foreign countries. All other problems may be conveniently solved by mutual consultation as the Directors of the Board shall meet together while confronted with emergencies or at least once a year.

As to the method of investments, priority must be given to the development of natural source in which a Muslim country is in an advantageous position over others. This will pave the way for economic internationalism which, as

opposed to economic nationalism (a potent cause of the World War II), shall contribute largely to the peace and prosperity of the world.

Here is again a problem of *riba* (interest or usury). In view of the particular form and features of this bank and to avoid *riba* it may be lawful to adopt the system of investment based on the sharing in of the profit and loss according to the specified terms as provided under *shirkat al-Inan*. Unlike commercial banks which have to deal with a very large number of borrowers, the investment transactions, here, will be limited in number and may be conveniently participated under the terms of the contract. Parties to the contract being Islamic States, and such others as are guaranteed by them, may be trusted and relied upon so far as the dealings are concerned.

The establishment of such institutions will not only develop the resources of the Islamic states but also unite them together in close co-operation and mutual help which itself negates the idea of *riba*.

These are our suggestions which may be improved upon and modified in the light of experience without, in any way, violating the fundamentals of Islam.

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