



The Origins and Evolution of Islamic Law and Finance

from the book- *Islamic Banking: Steady in Shaky Times?*

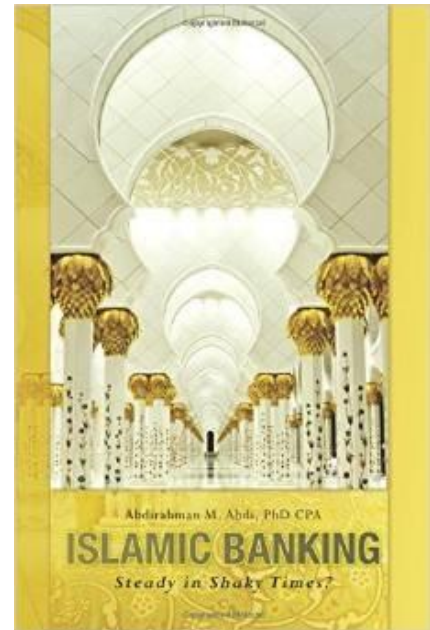
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Editor's Note: *The Origins and Evolution of Islamic Law and Finance, is a chapter from the book- Islamic Banking: Steady in Shaky Times? written By Dr. Abdirahman Mohamed. Among many topics, the book examines the stability and performance of financial institutions and "if there is empirical support for the assertion that Islamic Banking are more stable than the conventional institutions".*

Of all the many religions, Islam is the only one today that requires banking and other financial activities to be carried out in a way that is compatible with its laws. Other religions, such as Judaism and Christianity, have similar ethical standards, but today the concept of interest goes largely unquestioned.¹

Many countries prohibited "usury" by law for many centuries. In the Middle Ages, while Catholic Canon law forbade the use of interest, this did not apply to Jews. Whilst the Torah condemns interest, this was interpreted as meaning between Jews, and Jews became renowned as moneylenders, even helping to fund many national purses.



¹ For a comparison of the attitude of Muslims and Christians toward interest, see chapter 8 of L. M. Algaoud and M. Lewis, *Islamic Banking* (Northampton, MA: Edward Elgar, 2001).

Modern conventional modes of banking date back to the industrial Revolution of more than two and half centuries ago.² Up to that time, the merchants, moneylenders, and goldsmiths provided embryonic financial services.

A. Historic Origins of Islam to the Present

Prophet Mohammad (ﷺ) was born in Mecca in what is now Saudi Arabia in AD 570 into a regionally prominent tribe known as Quraysh (Jackson-Moore 2009, 2). Following the death of his father and mother, Prophet Mohammad (ﷺ) was brought up first by his grandfather Abdul-Muttalib and after his grandfather's death, by his uncle Abu Talib.

At the age of forty, while retreating to a lonely cave on Mount Hira for solitude and contemplation during the month of Ramadan, he was shaken to find himself in the presence of the angel Gabriel, who ordered him to recite³ words. Angel Gabriel began to appear to the Prophet on a regular basis. Gradually, Prophet Mohammad (ﷺ) gathered around him a small band of followers, but his tribe, Quraysh, became very hostile to him since he preached for people to abandon their worship of idols and instead worship only the one God.

Eventually, Quraysh persecuted Prophet Mohammad (ﷺ) and his followers, and when the persecution became too severe, the Prophet and his followers left Mecca and migrated to Medina, where the inhabitants welcomed them. This was in AD 622, and the year of migration (*hijrah*) marks the first year of the Muslim calendar, which is represented by the letters "AH" (after *hijrah*).

Prophet Mohammad (ﷺ) lived between the years AD 570 and 632, which is approximately some fifteen centuries ago. The major division in Islam would occur as a result of political differences over whether the leader of the Muslim community should always be a descendent of the family of Ali ibn Abu Talib (AD 595–660), the Prophet's cousin, or not. This gave birth to the Shi'a sect of Islam (this will be discussed in greater detail later in the chapter).

After the Prophet's death in AD 632, the leadership of the Muslim community passed to his great friend and companion, Abu Bakr, the first of the four "rightly guided" caliphs (successors of the Prophet) (Hallaq 1997). Over the next five hundred years, Islam continued to expand through sub-Saharan Africa and Asia Minor, and through the Moors to Southern Spain.

Bernard Lewis, author of *What Went Wrong? Western Impact & Middle Eastern Response* notes that Islamic power was at its peak from the ninth through to the thirteenth centuries. During this era, Islam represented "the greatest military power on earth—its armies, at the very same time, were invading Europe and Africa, India and China. It was the foremost economic power in the

² According to Niall Ferguson (2008), there was an explosion of financial innovation after the publication of *The Wealth of Nations* in 1776 with the variety of different banks that proliferated in Europe and North America.

³ The Prophet did not know how to read and write, so he memorized all revelations by reciting them aloud.

world [and] it had achieved the highest level so far in human history in the arts and sciences of civilizations."p.6.

The extraordinary enterprise represented by Muslim scholarship, science, religion, and commerce probably reached its highest level of achievement at the end of the fifteenth century; the reversal since that time has been quite remarkable (Lewis, D. L. 2008). From around the middle of the sixteenth century, Islamic learning began to be superseded by a dramatic growth of knowledge in the West.

Although, the fall of Constantinople to the Ottomans in 1453 prompted a mass exodus of Byzantine scholars to Rome and other European centers of learning (Runciman 1965), centuries earlier the flow of knowledge from intellectual and scientific centers extending from Baghdad to Andalusia created the very foundation of the Renaissance that changed European history.⁴

Later, many factors contributed to the decline and fall of the Islamic civilization. The invasion of the Crusaders, Iberians and the Mongols on Islamic lands between the eleventh and fifteenth centuries—especially the Crusade series of invasions that lasted from 1095 to 1291—are considered to be the most significant factor in the demise of the Islamic civilization. The Crusaders occupied or dominated via piracy Muslim ports on the Eastern Mediterranean, destroyed agricultural infrastructure in the Levant displacing farming communities, and forced Muslims to spend vast resources on the military. Correspondingly, Mongols destroyed Muslim libraries, observatories, hospitals, and universities culminating in the destruction of Baghdad, the Abbasid capital (Hassan, A. Y. 2001). Ibn Khaldun's *Muqaddimah* ("Introduction")⁵ written in 1377 points out that science was declining in Iraq, Al-Andalus (Spain), and the Magreb. The conflicts between Sunni and Shi'a Muslims further exacerbated the weakening of the Islamic empire. Political as well as economic factors were major causes that contributed to the decline as also stated in Ibn Khaldun's other book *Assabiyyah* ("Social Cohesion").

Muslim scholars and observers of the Islamic world wrote extensively about the economic problems that instigated its decline, such as corruption, favoritism, oppression, natural calamities, internal conflicts, foreign invasions, over spending on militarization, and higher taxes (Al-Omar, 2003). Besides, many Muslim observers advocated for socioeconomic reforms and appreciated at least some of the material products of Europe's transformation; such as shipbuilding techniques and new agricultural products and technology.

⁴ The Renaissance was a cultural movement that profoundly affected European intellectual life in the early modern period and it was founded upon the medieval sciences of Islam, which were themselves built upon the classical traditions lost to the west during the Germanic destruction of the Roman Empire. Beginning in Italy and spreading to the rest of Europe by the sixteenth century, its influence affected literature, philosophy, art, politics, science, religion, and other aspects of intellectual inquiry (Lewis, D., 2008 and Kennedy, 2007), in addition Italy's city-states were major maritime economic centers controlling trade at the Eastern Mediterranean and Black sea till mid-to-late the 15th century.

⁵ Ibn Khaldun, *The Muqaddimah: An Introduction to History*, abridged and edited by N. J. Dawood, (Princeton University Press, 1967).

Vasco Da Gama's arrival off the Malabar Coast of India in 1498 marked the beginning of the end of long-standing Muslim domination of trade in the Indian Ocean and beyond. Little by little, Muslims began to lose out to economic, technological, and military advances of the West, and the Islamic world entered into a long, slow process of decline, drawn out over centuries, culminating in colonization by the West and the dividing up of the Ottoman Empire in the aftermath of the First World War (Hussain 1999, 11–23).

B. Sources of Islamic Law

Muslims' lives are ruled by the *Shari'a* (Islamic law). Literally, the word *Shari'a* can be translated as "the path that leads to the spring" (Ramadan 2004, 31). Figuratively, it means "a clear path to be followed and observed." Islamic religious law emanates from various sources. By far the most important source is the *Holy Qur'an*, the collection of the revelations to Prophet Mohammad (ﷺ). The *Holy Qur'an* is obviously not purely a legal text; nevertheless, it does contain approximately five hundred injunctions of a legal nature (twenty of which are on economic issues) (Doi 1989, 38–39).

The Sources and Techniques of Islamic Law

Primary Sources	<p><i>qur'an</i> (the book containing the message of Islam). Muslims believe that it is the word of God as conveyed to Prophet Mohammad (ﷺ).</p> <p><i>sunna</i> (collection of the words or acts of the Prophet or the <i>ahadith</i> which Prophet Mohammad (ﷺ) used to give for moral guidance on many issues).</p>
Secondary Sources	<p><i>ijma'</i> (consensus)</p> <p><i>qiyas</i> (analogy)</p> <p><i>ijtihad</i> (individual interpretation)</p>
Minor or Subsidiary Techniques	<p><i>istihsan</i> (juristic preference)</p> <p><i>istislah</i> (public interest)</p> <p><i>urf</i> (custom)</p>
Some Principles	<p><i>darura</i> (necessity)</p>

The *Qur'an* and the *Sunna* are the primary sources of Islamic law. They are thought to contain God's infallible and immutable will, or *Shari'a* in a narrow sense.

However, the *Qur'an* and the *Sunna* are silent on many issues that contemporary Muslims are facing. Furthermore, the *Qur'an* and the *Sunna* leave room for different interpretations. Muslims, therefore, often resort to secondary sources of law⁶. *Shari'a*, in a wide sense, includes all Islamic legislation. In so far as this is based on secondary sources, it is not necessarily valid for all times and all places.

It was Imam al-Shafii in the early ninth century (the founder of the Shafii school of law, see following section) who "authoritatively insisted on human reason as the final judge on matters not regulated by the *Qur'an*" (Hallaq 1997, 21). Imam al-Shafii stated that there are two secondary sources of law: *ijma'*, or consensus; and *qiyas*, or analogy. Together with the primary sources, they are the four principal *usul al-fiqh*, or fundamentals of jurisprudence (see table 7.1 above).

- *Ijma'* (consensus)—the informed consensus of the community of scholars was established, not for matters of faith or fundamental observances, which were agreed upon, but on the application of *Shari'a* to worldly affairs. This is a source of importance for Islamic finance because models of Islamic banking are not mentioned in either the *Qur'an* or in the hadith, the primary sources that govern the system. Consequently, the development of Islamic banking has been based to a large degree on the consensus of modern Muslim scholars and jurists at both national and international levels. Hence decisions made in this manner are *ijma'*, the collective judgments of learned Muslim scholars, the *ulama*.
- *Qiyas* (analogical deduction)—additional sources of law are *qiyas* (analogy from established law).
- *Ijtihad* (formation of law by the individual's struggle for proper understanding)—using reason and judgment to determine a course of action in keeping with the spirit of the *Holy Qur'an* and hadith is called *ijtihad*.
- *Istihsan* (juristic preference)—this points to exceptions that a jurist can make to a strict or literal legal interpretation (Esposito 2003, 152). *Istihsan* can be applied to *qiyas*, or any other method, and does not provide a definite answer.
- *Istislah* (literally, "seeking the good" (Ramadan 2004, 38), or taking the public interest, *maslaha*, into account. Jurists have differing opinions over the scope of *istihsan* or *maslaha* as a source of law.
- *Urf* (customary practice)—this is recognized, within limits, by the Hanafi and Maliki Schools but rejected by the Shafi'i School. According to the Hanafi School, for example, *urf* or custom may prevail over *qiyas* but never over a *nass*, a text of the *Qur'an* or *Sunna*. The paramountcy of *nass* is in fact the common limitation of all the minor techniques as

⁶ For example, Muslims have relied on the *ijma'*, *qiyas* or *ijtihad* to distinguish between what is prohibited or permitted in modern times such as brokerage, insurance (Al-Qaradawi, 2006) or the usage of banknotes.

well as *ijma'* and *qiyas*. *Ijtihad* in general is believed to be permitted only in matters not covered by clear and definite *nass* or text of the *Qur'an* or *Sunna*.

- *Darura* (necessity)—this may be seen as being derived from *qiyas* or analogy to a principle contained in verses of the *Qur'an*, such as the ones permitting a Muslim to eat forbidden food, such as pork, or do an impermissible thing if that is the only way to preserve his or her life. The key question here is, of course, what constitutes a legitimate necessity of the degree justifying deviation from or relaxation of the strict rules of *shari'a*?

C. Islamic Schools of Thought

Unlike Christianity, classical Islam had no priestly hierarchy and no central religious authority to promulgate official doctrine; truth needed no authorization. The nearest to clergy in Islam are the jurists known as the *ulama* (from *alim*, meaning a jurist or scholar), who differ in their roles and gradation.

The most important sectarian division in Islam is the one that separates Sunni and Shi'a believers, which arose in AD 661 on the question of the rightful leadership of the community. Shi'ism, which has various subsects, is predominantly in Iran, and has a significant number of followers in Iraq, India, and many of the Gulf states. There are considerable doctrinal differences between the Shi'a and the four Sunni Schools of Islamic jurisprudence, in terms of who is permitted to interpret *Shari'a* law.

Sunni legal doctrine has four main schools, each with its own system of theory and applications of law, although each recognizes the legitimacy of all of the others. The four orthodox schools are:

- The *Hanafi* School—this is the oldest one. It derives its name from Abu Hanifa, a Persian who taught in Iraq and died in AD 767. It is the most flexible of the four schools, emphasizing private interpretation, *ray'*; juristic preference, *istihsan*; and reasoning by analogy, *qiyas*. *Ijma'*, consensus, is also accepted. This is the prevailing school in India and the Middle East.
- The *Maliki* School—this school was founded by Malik ibn Anas, who died in AD 795 in Medina. It accords *qiyas* (analogy) a larger place than the other schools; Malik seems to have given priority to *qiyas* over *ahaad* (*ahadith* with a weak chain of transmitters (Al-Mukhtar Al Salami 1999, 22)). Nonetheless, the Malikis strongly rely on the hadith and also on *ijma'* (consensus) of the scholars of Medina, where Prophet Mohammad (ﷺ) lived after he had fled Mecca. The Moors and Arabs who ruled Spain were followers of the Maliki School. Today, it is found mostly in North, West, and Central Africa.
- The *Shafi'i* School—its founder was Mohammad ibn Idris al Shafi'i, an Arab who died in AD 820 in Egypt. He was a pupil of Imam Malik and is thought by some to be the most distinguished of all jurists. He was famed for his modernization and balanced judgment. He rejected the personal view of scholars (*ijtihad* in the form of *ray'*), juristic preference

(*istihsan*), and considerations of public welfare (*istislah*), but fully accepted consensus (*ijma'*). Followers of the Shafi'i School today are found predominately in Southeast Asia (Malaysia, Indonesia), Yemen, Egypt, and Somalia.

- The *Hanbali* School—this school was founded by disciples of Ahmad ibn Hanbal, who died in AD 855 in Baghdad. The Hanbali base themselves exclusively on the *Qur'an* and the *Sunna*, and the only *ijma'* that is accepted by this group is the consensus of the companions of the Prophet, among whom are the rightly guided caliphs. The Hanbali School today is predominant in Saudi Arabia. The most famous Hanbali scholar is Ibn Taymiyya (1263–1328), who "emphasized the literal truth of the *Qur'an* and rejected independent reasoning, in line with his rejection of Aristotelian logic" (Visser 2009).

Ibn Taymiyya's writings influenced Mohammad ibn Abdul Wahhab, an eighteenth-century Sunni Muslim scholar, who founded the puritan Wahhabi movement of Saudi Arabia. He advocated a process of purifying Islam from what he considered innovation (*bidah*) by following a strict interpretation of Islamic jurisprudence based only on the *Qur'an*, *ahadith*, and the understandings of the companions of the Prophet (*sahaabah*). It has developed considerable influence in the Muslim world through the funding of mosques, schools and other means of transmission by wealthy individuals or groups in Saudi Arabia and other Gulf states.

There is a tendency for non-Muslims and those with rudimentary understanding of Islam to confuse what the term "Islamic law" entails. To clarify, the English term "Islamic law" conceals an important distinction between *Shari'a* and *fiqh*. *Shari'a* is totally divine. Allah is the One who dictates the laws, which were revealed to Prophet Mohammad (ﷺ) (Auda, 2008). *Fiqh*, on the other hand, is a human endeavor to understand *Shari'a* laws. Therefore, Muslims must obey *Shari'a*. But note, *fiqh* cannot be enforced on all Muslims. Followers of any School of *fiqh* are only subject to follow its *fatwas*. From the beginning, starting with Prophet Adam, *Shari'a* changed based on the needs of the community. Allah revealed different *Shari'as* to people throughout the history of mankind. However, the *Shari'a* of Prophet Mohammad (ﷺ) sealed all *Shari'a* laws, therefore it is final.

The situation is further complicated by the different positions taken by the various schools of thought. For example, one might consider the varying perspectives of the different schools with regard to *bay' al-salam* (forward-purchasing contracts). The term refers to a contracted sale whereby the seller undertakes to supply specific goods to the buyer at a future date in exchange for an advanced payment up front. According to the Hanafi School, it is necessary that the commodity that is being sold remains available in the marketplace from the very day that the contract is initiated right up until the date of actual delivery.

If the commodity is not available in the marketplace at the time of the contract, *bay' al-salam* cannot be effected in respect to that commodity, even though it may be confidently expected that the commodity *will* be available in the marketplace on the agreed delivery date. The other three schools of thought—Shafi'i, Maliki, and Hanbali—differ on this and are of the opinion that the availability of the commodity at the time of the contract is not a condition for the validity of *bay'*

al-salam. According to them, what is necessary is that it should be available at the time of delivery.

Another example of differences among the various schools of law is the case of when fruit can be sold. The Shafi'i and Hanbali jurists categorically prohibited the sale of unripe fruits; the Malikis and some of the Hanafis allowed "the sale of fruits...which ripen in succession during one harvest, if such sale accompanies the sale of what has already ripened" (Saleh 1986).

These are only two examples, but suffice to say, there can be considerable divergence between what is and is not permissible under Islamic law, depending on which school of thought or law is consulted. Such inconsistencies are not in themselves conceived as some kind of failure on the part of Islamic jurisprudence, but rather as a reflection of the fallibility of man. Ultimately, *fiqh* rulings are taken as truly and certainly God's law only when they are agreed upon *unanimously* by all Islamic scholars of a particular era. The latter agreement is called *ijma'* or consensus (Vogel and Hayes 1998, 34–35).

Malaysia, which is on the forefront in the development of Islamic financial products and follows the Shafi'i School of thought, introduced *bay' al-'inah* (a transaction in which somebody sells goods for cash and then buys it back from the same person at a higher price in exchange for deferred payment). However, the other three Islamic schools of law or thought consider this transaction as *hila* (ruse or legal artifice) to get around the prohibition of *riba* (interest) (Warde 2007).

Another unique financial product offered to investors in Malaysia is *bay' al-dayn* (the trading of debt in the secondary market) under the concept of *sukuk al-ijara* (certificates of leasing)—only documents evidencing debt arising from bona fide commercial transactions can be traded. Outside of Malaysia, most scholars consider debt trading to be noncompliant with *Shari'a* law (Warde 2007).

D. Revival of Islamic Finance

From the very early stages of Islamic history, Muslims were able to establish a system without interest for mobilizing resources to finance productive activities and consumer needs. The system to finance business transactions was based mostly on the profit-and-loss-sharing (PLS) modes of *mudaraba* (passive partnership) and *musharaka* (active partnership). Deferred trading and *qard hasan* (interest free loans) were also used to finance consumers' as well as businesses' transactions.

The system worked very effectively during the early days of Islamic civilization and for centuries thereafter. The Islamic modes of financing (*mudaraba* and *musharaka*) were able to mobilize the necessary financial resources at the beginning of Islamic civilization for the financing of long-distance trade, manufacturing, and agriculture.

Given the factors that I stated earlier were responsible for the decline of Islamic civilization, the Muslim world lost its technological and economic vitality. Therefore, conventional institutions displaced most Islamic institutions, including the Islamic system of financial intermediation.

However, the independence of Muslim countries has led to the revival of Islam, and there is a strong longing to gradually reinstate most of the lost institutions, the Islamic financial system being one of them.

In the early 1960s, there was enough demand for *Shari'a*-complaint banking that it culminated in the creation of the *Mit Ghamr* Local Savings Bank in Egypt in 1963, founded by a noted social activist Ahmad-al-Najjar. It is modeled on Germany's *Sparkassen* (savings bank), employing profit-sharing techniques for financing rural small businesses. The establishment of Dubai Islamic Bank in 1975 is considered to be one of the earliest private initiatives in the United Arab Emirates. The 1970s witnessed the rise in the price of oil leading to the accumulation of oil revenues in several oil-rich Muslim countries, especially in the Middle East.

This oil revenue from the 1970s, also known as "petro-dollars," offered strong incentives for creating suitable investment outlets for Muslims wanting to comply with *Shari'a*, interest-free, or Islamic banking, which was a concept that by the early 1970s had found a strong business case to be explored further. Both domestic and international bankers, including some of the leading conventional banks, exploited this business opportunity.

Deregulation in the 1980s and 1990s in the United States and many other countries proved to be a boon for Islamic finance, as it fostered the creation of tailor-made Islamic products. Until then, financial institutions could only sell a narrow range of financial products. With the lifting of constraints on the products that "financial engineers" could devise to suit every need—religious or otherwise—countless new Islamic products could be created.

In recent years, the growth of the Islamic sector has greatly accelerated. This trend is being driven by a combination of factors. The most obvious one is the impact of surging oil prices and the related economic boom in the Gulf region. Excess liquidity has raised the demand for a wider range of financial products. Related factors include what could be broadly described as the "September 11 effect"—a combination of rising religious and nationalist sentiment since the launch of the "War on Terror." This increased religiosity translated into greater demand for Islamic financial products.

Also, unlike during the oil boom of the 1970s, more of the financial revenues are staying within the Islamic world. Another aspect of the new environment is the growing convergence of the Arab and Malaysian models of Islamic finance, which became an essential building block in the rationalization and harmonization effort.⁷

A crucial development was the freezing of the assets of Middle Eastern individuals and the crackdown on Islamic financial institutions and charities, which led many Muslim investors to take a significant chunk of their assets out of the United States. Home markets could not absorb all those withdrawals (estimated at about two hundred billion dollars), and the quest for a new diversification strategy led more or less naturally to Malaysia, a Muslim country that had

⁷Ibrahim Warde, "Islamic Finance after September 11: Toward Arab-Malaysian Integration" (Seattle, WA: National Bureau of Asian Research, 2007).

achieved an impressive level of economic development. Other forms of political and economic development also intensified. Malaysia started working closely with Arab regulators, especially those of Bahrain and the United Arab Emirates, on matters of Islamic finance.

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