CHAPTER 1

Historical Developments

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The evolution of Islamic finance in modern history is only a small part of overall banking history, and in its current form only spans a period of around 60 years. This does not imply that Islamic finance did not exist prior to the mid-1960s. Comparable to other modes of financing, it has gone through periods of increased as well as diminished popularity, and ceased to exist for long periods of time. This chapter will look at the general history of banking as well as the way Islamic finance has evolved.

1.1 THE HISTORY OF FINANCE

Financial services have historically always played an important role in the economy of every society. Banks mobilise funds from investors and apply them to investments in trade and business. Although the actual origin of banking is difficult to determine, the history of banking is long and varied, and the financial system as we know it now is generally ascribed to the Florentine bankers of the fourteenth to seventeenth centuries AD.[1] The word "bank", for example, is derived from the Italian word *banco* (for the merchant's bench). Interestingly enough, the word "bank" also assists in tracing the origins of "bankruptcy", which relates to the breaking of a merchant's bench in medieval Italy as a signal of failure. Whether it be safe keeping, money changing, investing funds on behalf of others or making other capital goods such as land available at a charge, financial services have been around in some form for a long time. Even pre-dating the invention of money, safekeeping of valuables was long a task ascribed to religious temples. Deposits would initially have consisted of grain, but also other valuable goods such as cattle and agricultural implements, followed by precious metals such as gold. The latter would typically have been stored in a form that was easy to transport such as plates or bars. There were good reasons to store valuables in temples: the continuous stream of visitors would make it difficult for any thief to go about his business unnoticed, in addition

[1] Green, E. (1989) *Banking: An Illustrated History*. New York: Rizzoli.

to which they tended to be well built, making them secure. Perhaps even more importantly, temples were sacred places that were deemed to provide additional protection against potential thieves.

Evidence exists of priests in Babylon lending money to merchants as early as the eighteenth century BC, and the *Code of Hammurabi*,[2] believed to have been written around 1760 BC, includes laws governing banking operations in ancient Mesopotamia. Although not the first known law, it is the best-preserved one. Table 1.1 provides some examples of the laws in the code that are related to financial services.

In addition, any compensation for loss of articles in safekeeping and the amount of rent to be paid for having the usufruct[3] of land and different species of livestock was clearly defined.

TABLE 1.1 Selected entries from the Code of Hammurabi

Law	Description
48	If any one owe a debt for a loan, and a storm prostrates the grain, or the harvest fail, or the grain does not grow for lack of water; in that year he need not give his creditor any grain, he washes his debt-tablet in water and pays no rent for this year.
49	If any one take money from a merchant, and give the merchant a field tillable for corn or sesame and order him to plant corn or sesame in the field, and to harvest the crop; if the cultivator plant corn or sesame in the field, at the harvest the corn or sesame that is in the field shall belong to the owner of the field and he shall pay corn as rent, for the money he received from the merchant, and the livelihood of the cultivator shall he give to the merchant.
50	If he give a cultivated corn-field or a cultivated sesame-field, the corn or sesame in the field shall belong to the owner of the field, and he shall return the money to the merchant as rent.
51	If he have no money to repay, then he shall pay in corn or sesame in place of the money as rent for what he received from the merchant, according to the royal tariff.
52	If the cultivator do not plant corn or sesame in the field, the debtor's contract is not weakened.
119	If any one fail to meet a claim for debt, and he sell the maid servant who has borne him children, for money, the money which the merchant has paid shall be repaid to him by the owner of the slave and she shall be freed.
121	If any one store corn in another man's house he shall pay him storage at the rate of one gur for every five ka of corn per year.

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[2]The Code of Hammurabi was a comprehensive set of laws, considered by many scholars to be the oldest laws established. Although the Code of Hammurabi was essentially humanitarian in its intent and orientation, it included the "eye for an eye" theory of punishment, which is a barbarian application of the concept of making the punishment fit the crime. The Code of Hammurabi recognised such modern concepts as that of corporate responsibility. See also King, L.W. (2004) *The Code of Hammurabi*, Montana: Kessinger Publishing.

[3]Usufruct is the legal right to use and derive profit or benefit from property that belongs to another person. It originates from civil law, where it is a real right of limited duration on the property of another. A lease contract, in which one party allows another to use but not own a good, is a form of transfer of the usufruct.

In the Roman Empire, money lenders would conduct their transactions from benches in the middle of enclosed courtyards rather than setting up shops. The ancient Roman money lenders merely converted any currency into the currency of Rome, which was the only legal tender in the city, and are not known to have provided any further financial services.

At the time of the ancient Greeks, bankers not only converted currency but also invested in projects and other businesses. Banking was no longer restricted to temples, and other entities such as money changers also conducted financial transactions including loans, deposits, exchange of currency and validation of coins. Trade finance, in the form of letters of credit, flourished. Money lenders in one city would, against a fee, write a credit note that could be cashed elsewhere in the country, which meant that no coins needed to be carried around on their journey, nor did guards have to be hired to protect it. Interestingly enough, most of the early bankers in Greece were foreign residents, and there is little known about the individual bankers themselves, although records have been found relating to Pasion (*c*.430–370 BC), originally a Phoenician slave, who rose to be one of the wealthiest citizens in Athens and owned one of the most successful private banks in Athens.[4]

Credit-based banking spread in the Mediterranean world from the fourth century BC. In Egypt grain has long been one of the most used forms of money, in addition to precious metals. State granaries functioned as banks, and when Egypt briefly fell under Greek rule, the government granaries were transformed into a network of grain banks with a centralised head office function in Alexandria. Payments could be effected by transfers between accounts without any physical money changing hands.

The Romans then perfected the administrative aspect of banking and introduced enhanced regulations of financial institutions, in the wider sense of the word. The practice of charging and paying interest developed further and became more competitive. However, as a direct result of the Romans' preference for cash, the development of the banking system itself was limited. Additional restrictions were introduced on the banking system by theologians and philosophers, mainly due to the fact that the charging and paying of interest was deemed to be immoral. With the fall of the Roman Empire, banking declined significantly in western Europe and did not feature again until the time of the Crusades from the late eleventh century AD.

The Crusades, in combination with the expansion of European trade and commerce, led to an increase in the demand for financial services. As a result of people travelling to a variety of different countries, there was a significant demand for money-changing services. Any service that would make it possible to transfer large sums of money without the complications of having to carry chests full of gold around and requirements for elaborate precautions against theft was particularly in demand. Crusades were expensive and the participants often had to borrow money, which was regularly done by mortgaging land and buildings. The terms were, however, far more favourable to the lender than to the borrower, as a result of which the demand for mortgages deteriorated over time.

The development of international trade led directly to the requirement for a foreign exchange type contract, the first of which was recorded in 1156 in Genoa.[5] The use of these types of contracts expanded significantly, not only because of the requirements following the

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[4] Shipton, K.M.W. (2012) Pasion, Athenian banker. In R.S. Bagnall (ed.), *The Encyclopedia of Ancient History*. Hoboken, NJ: John Wiley & Sons.

[5] Two merchant brothers borrowed 115 Genoese pounds to reimburse the bank's agents in Constantinople by paying them 460 bezants one month after their arrival in Constantinople.

development of international trade, but also since profits from time differences in a foreign exchange contract were not covered by canon laws against usury.

Financial contracts of this time were largely governed by Christian beliefs, which prohibited interest on the basis that it would be a sin to pay back more or less than what was borrowed. In addition, justness of price and fairness were important underlying guiding principles that applied to society as a whole and included financial services. The evolution from an interest-free to an interest-based banking system did, of course, not happen overnight, but was based on a number of factors such as the change from agrarian to commercial economies, the move towards pricing on the basis of supply and demand, decentralisation of the Church, and the recognition of money as a factor of production.[6]

During the Middle Ages, until the thirteenth century, the Church was the largest single entity possessing significant wealth and was an important lender. However, the impact of the Church declined, and as commerce flourished and generated more wealth than could be reinvested in commerce alone, it was the merchants who lent the money to finance individual and government consumption.[7] Initially only lending their own money, some of the merchants became merchant bankers lending both their own capital as well as capital deposited with them by others.

While in most of Europe the Christian prohibition of usury was still in place, charging interest was, however, legalised in Valencia in 1217 and Florence in 1403. The legalisation of interest in Florence was more significant for the development of the banking industry as we know it now since the Florentine bankers, who already had a presence in a number of European countries, started to offer loans and deposits on an interest basis.

In the UK, London was the main centre of trade and hence the majority of financial transactions were executed there, mainly from the many coffee houses in the City. In 1565, the Royal Exchange was established in London to act as a centre of commerce, and some of the banking business moved there too. However, during the seventeenth century stockbrokers were expelled due to their rather rowdy behaviour, and the buying and selling of stocks was again confined to the coffee houses.

In the early part of the seventeenth century Amsterdam started to grow into a major trade hub, which in turn resulted in it becoming the financial centre of the world. It managed to maintain this position until the Industrial Revolution in the late eighteenth and early nineteenth centuries, and was home to the first ever recorded economic bubble, due to tulip mania. The tulip was first brought to Holland in 1593 from the Ottoman Empire, and became so popular that in 1623 a single tulip bulb could fetch as much as 1,000 florins, which was equivalent to 6.7 times the average annual income. By 1636 the price had risen to unsustainable heights, and the bubble burst in 1637 as a result of an absence of buyers and abundance of sellers. Tulip mania[8] was only the first economic bubble of its kind. Inflated asset prices have since given rise to a multitude of busts and booms, the most recent ones being the dot.com boom and the subprime mortgage crisis.

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[6] DiVanna, J. (2008) A cloud is a promise, fulfilment is rain, *New Horizon*, 167, 20–22.

[7] Supple, B. (1977) The nature of enterprise. In E.E. Rich and C.H. Wilson (eds), *The Economic Organization of Early Modern Europe*. Cambridge: Cambridge University Press: “Commercial enterprise was more a source than a use of capital” (p. 423).

[8] Dash, M. (1999) *Tulipomania*. London: Victor Gollancz.

The Industrial Revolution put America and the UK firmly on the map of international finance. With this shift of emphasis, the banks in these countries gradually gained importance over time. London and New York became the major financial hubs, later on joined by Hong Kong, Tokyo and Singapore. The main financial centre in the Middle East has long been Lebanon, until the war broke out in 1972 and the banks started to move to Bahrain and later Dubai. Increasing internationalisation in trade, commerce and manufacturing applies to banks as well and was often achieved by a combination of the establishment of new branches and acquisitions. In addition, banks started to offer financial services across the whole spectrum, from retail to wholesale, with the side effect that the once numerous small banks have now mainly merged into a few large conglomerates offering increasingly complex financial solutions. Few relatively small banks remain.

The events of 2007 and 2008, beginning with the subprime crisis, which was largely considered to be an American problem, led to unprecedented liquidity problems and resulted in the bankruptcy of Lehman Brothers[9] and the forced sale of others such as Bear Sterns in March 2008 and Merrill Lynch in September 2008.

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1.2 THE HISTORY OF ISLAMIC FINANCE

During medieval times, Middle Eastern tradesmen would engage in financial transactions on the basis of *Sharia'a*, which incidentally was guided by the same principles of justness in exchange and prohibition of usury that were also applied by their European counterparts at the time. They established systems without interest that worked on a profit- and loss-sharing basis. These instruments catered for the financing of trade and other enterprises and worked very effectively during and after the era known as the Islamic civilisation, which lasted from the late sixth to the early eleventh century AD. Over time, Western countries started to play a more and more important role in the world economy and as a result Western or conventional financial institutions became more dominant.

As the Middle Eastern and Asian regions became important trading partners for European companies such as the Dutch East India Company, European banks started to establish branches in these countries. The finance system they introduced was typically interest-based. On a small scale, credit union and co-operative societies continued to exist but the scale of their activities was very much focused locally on small geographical areas.

Although it was not until the mid-1980s that Islamic finance started to grow exponentially, the first financial company in recent history based on *Sharia'a* principles was the Mit Ghamr savings project in 1963. This financing project worked on a co-operative basis, and depositors had the right to take out small loans for productive purposes. In addition, the project attracted funds to invest in projects on a profit-sharing basis. The Mit Ghamr savings project was set up to allow the local population to have access to banking services and, where possible, to obtain a return on their money. In 1971 the project was incorporated in Nasser Social Bank. Around the same time as the Mit Ghamr savings project, financial services based on *Sharia'a* were set up in Malaysia, again to cater for the generally under-banked Muslim population. The earliest financial services offered in Malaysia were savings plans for the pilgrimage (*hajj*) to Mecca.

[9] Lehman Brothers was officially deemed a defaulting counterparty on 15 September 2008.

In 1975, the Islamic Development Bank was established in Jeddah as a multilateral development bank assisting in mobilising funds for investment for projects in the member states. In the same year, the Dubai Islamic Bank was founded in the United Arab Emirates as the first privately established Islamic bank.

The years since 1975 have seen the establishment of many more banks and the development of the industry into a multibillion-dollar market. It is no longer just small banks offering Islamic finance. These banks themselves are growing, and large conventional banks are offering Islamic finance through their "Islamic windows". Fully *Sharia'a* compliant banks and conventional banks are actively working together to offer Islamic finance, utilising some of the structuring and distribution capabilities of the larger banks. As a result, we are seeing increasingly large transactions being structured. As of 2015, in excess of 25 organisations in the UK are offering Islamic financial services, and the Prudential Regulation Authority (PRA) has regulated seven fully *Sharia'a* compliant financial institutions.[10] The UK is well on the way to achieving its goal to become the largest Islamic financial centre outside the Muslim world. France and the Netherlands have both also announced their intention to become the largest centres for Islamic finance, but the required changes to their tax and regulatory systems have not yet started.

The USA, originally hesitant and only permitting Islamic financial services to be offered offshore, has amended its perception and now also allows Islamic financial services on its territory.

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[10]The fully Islamic institutions authorised and regulated by the PRA are made up of one retail bank (Al Rayan Bank plc), four wholesale banks (European Islamic Investment Bank, Bank of London and The Middle East plc, Qatar Islamic Bank (UK), and Gatehouse Bank), one investment manager (Tejara Capital (UK)) and one insurance company (Cobalt Underwriting).