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Historical Development and Research Design

Islamic finance is as old as Islam itself, but over the course of its history the way of business has changed from the Barter System to the Dirham System and from the Dirham System to the Currency System. The way in which business was financed in earlier periods of trade is totally different from the way in which it is financed today. Islamic finance also remained in papers for many years and a practical, modern shape was only given to it with the establishment of the Dubai Islamic Bank in 1975. Today Islamic finance is emerging not only in Muslim countries but all over the world, irrespective of economic systems prevailing there. Over the course of the next few years Islamic banking is expected to become an expanding and emerging market as it is currently estimated to be increasing at an annual rate of 15 per cent.

2.1 History of Islamic Finance

The basic function of a conventional bank is to collect deposits from depositors and to disburse loans to borrowers. The bank’s source of profit is the difference between the interest rates offered on deposits and those charged on loans. A conventional bank, therefore, can be described as a financial institution whose current operations consist of accepting deposits from the public and issuing loans. Banks act as intermediaries when they mobilize savings from surplus units (savers) to shortage units (borrowers) in order to finance productive activities.1 At the macro level banks play an important role in the development of an economy. Historically, the financial industry has played an important role in the economy of every society. Banks mobilize funds from investors and apply them to investments in trade and business. The history of banking is a long and varied one, with the financial system as
we know it today descending directly from the system that was estab-
lished by the Florentine bankers of the fourteenth to the seventeenth
centuries. However, even before the invention of money, people used
to deposit valuables such as grain, cattle and agricultural implements
and, at a later stage, precious metals such as gold for safekeeping with
religious temples.

Around the 5th century BC, the ancient Greeks started to include
investments in their banking operations. Temples still offered safe-
keeping, but other entities began to offer financial transactions, includ-
ing loans, deposits, the exchange of currency and the validation of
coins. Such financial services were typically offered in exchange for the
payment of a flat fee or, for investments, against a share of the prof-
its. The views of philosophers and theologians on the matter of interest
have always ranged from an outright prohibition to the prohibition of
usurious or excess interest only, although there has generally been a
bias towards the absolute prohibition of any form of interest. The first
foreign exchange contract in 1156 AD was not executed simply to facil-
itate the exchange of one currency for another at a forward date, but
also because profits from time differences in a foreign exchange contract
were not covered by canon laws against usury. In a time when financial
contracts were largely governed by Christian beliefs prohibiting interest
on the basis that it would be a sin to pay back more or less than what
had been lent, this was a major advantage.

In the early years of Muslim history bankers were known as sarrāfs
or sayārifah. By the time of the Abbasid caliph al-Muqtadir (295–
320AH/908–932AC), they had begun to perform most of the basic
functions of modern banks.2 They had established their own markets,
something akin to Wall Street in New York and Lombard Street in
London, and fulfilled all of the banking needs of commerce, industry
and agriculture within the constraints of the then-prevailing technolog-
ical environment.3

The ability to mobilize financial resources, along with a combination
of several economic and political factors, provided a great boost to trade,
which flourished from Morocco and Spain in the West, to India and
China in the East, Central Asia in the North, and Africa in the South.
The extension of Islamic trade influence is indicated not only by the
available historical documents but also by the Muslim coins from the
seventh to the eleventh centuries found through excavations in coun-
tries like Russia, Finland, Sweden, Norway, the British Isles and Scotland,
which were on the very outskirts of the then-Muslim world.4

During medieval times (the period from roughly 1000 to 1500 AD),
Middle Eastern tradesmen would engage in financial transactions on the