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Creditor-Debtor Relations: Some Issues, Some Proposals

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This short paper is a "work in progress". It is being distributed with two purposes:

1. As a handout for a lecture to be delivered on May 12, 2012 through Video Conference, to be attended by audience from King Abdul Aziz University, Islamic Development Bank and ISRA Kuala Lumpur.
2. For Peer Review

It may not be quoted.

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1. Introduction

Debt has always been a controversial issue in economics. There is a school of thought that considers that leveraging is a useful way of increasing wealth. Debt can open up many opportunities for individuals, corporations and governments to meet the needs that their present incomes cannot afford and can also increase national income by putting idle resources into use.

There is another school that considers that debt except in very exceptional cases leads to misery, depression, both mental and economic, and gives others the chance to control your wealth, honor and freedom. Debt creates misunderstandings, malice, enmity between debtors and creditors and even war between nations.

Perhaps both of these are extreme views. However, in the opinion of this author the latter is much closer to reality than the former. In this paper, we make an effort to determine the role of debt in wealth creation and its appropriate limits. Our endeavor is to derive some principles that can help creating smoother relations between debtor and creditors, be it individuals, corporations or countries. Before doing that, however, we need to make an important distinction between a 'creditor' and a 'lender'.

2. Creditors versus Lenders: An Important Clarification

It is not a matter of semantics. The distinction between 'creditor' and 'lender' is important from an Islamic point of view. In modern finance, the difference between a 'debt' and a 'loan' has been obscured. The terms 'debt' and 'debtor' are often mixed up with 'loan' and lender respectively. For example, if we look for the definition for 'debt', we find in some famous dictionaries/resources the following definitions:

The Encyclopedia Britannica's article on debt reads "debt, something owed. Anyone having borrowed money or goods from another owes a debt and is under obligation to return the goods or repay the money, usually with interest".

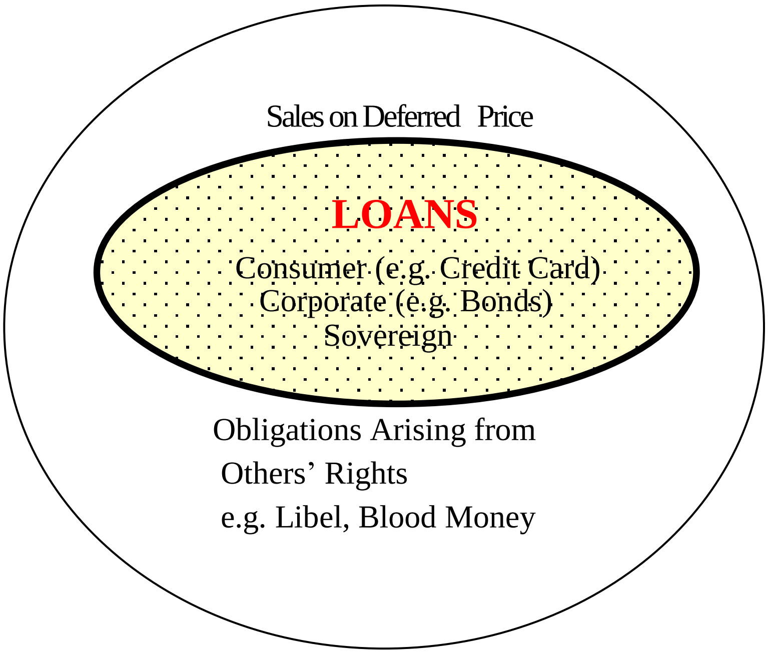
Farlex Financial Dictionary gives the definition of debt as follows:

"Any money owed to an individual, company, or other organization. One acquires debt when one borrows money."

Another influential source defines the term as:

"An amount of money borrowed by one party from another. Many corporations and individuals use debt as a method for making large purchases that they otherwise could not afford at the time of purchase. A debt arrangement gives the borrowing party permission to borrow money under the condition that it is to be paid back at a later date, usually with interest."

From an Islamic legalistic point of view, debt (debtor) and borrowing (borrower) ought to be distinguished from loan (lender) and credit (creditor). The Arabic word 'dayn' (debt is its close but not exact translation) has a wider meaning than 'loan'. Loan is only one of many contracts/ways that generate debt. In technical parlance, loan is a subset of debt. The idea is shown in the following diagram.



This distinction is important because in Islam loans and other types of debts have different roots. Unfortunately, even many Muslim writers often use the words interchangeably. The distinction is important because Islamic finance derives its rationale from the prohibition of *riba* in Islam. Now there is near consensus among Islamic jurists that modern bank interest falls within the preview of prohibited *riba*.

In a loan contract, the lender cannot earn a return (or obtain any benefit from borrower). However, return of his principal amount is guaranteed. That *riba* (interest) is prohibited in Islam does NOT mean zero rate of return to capital. It may be noted here that the Islamic position on interest is quite different from the position of Lord Maynard Keynes, one of the most influential economists in the history of capitalism. Keynes had suggested zero or near zero rate of interest as a means to ensure continuous full employment and distributional equity. His suggestion was to promote investment and aggregate demand, which in turn will increase income and employment. Other economists have described many problems that a one-sided increase in aggregate demand can cause. Later in this paper, we will also comment on the deficiencies of such a policy.

What Islamic position DOES, however, mean is that capital given as loan CANNOT earn a return. As against this, capital employed using other contracts, including trading can, and normally does, earn a return. For example, in Islamic finance, if *bay al- murabahah*, a trading contract is used, the seller sells a commodity on a price which includes cost plus an agreed amount of profit. The payment of price can be and is normally delayed. Thus the contract creates a debt. Now, once a debt has been created, the creditor cannot ask the debtor to pay anything more than the deferred price. The seller earns a return on his capital but only once.

The conclusion of the above discussion is that Islamic prohibition of *riba* applies to ALL types of debts, not only to loans. Similarly, the guarantee of the 'principal' applies to ALL types of debts, not only to the debts generated by loans. Loans and debts are treated equally in terms of the principal amount but differently in terms of getting a return on the principal. Another important point to remember here is that the return that the owner of capital gets is against a risk that he has taken in using his capital in a particular way. Similarly, the capital of a lender is guaranteed because he did not take any risk with his capital. Therefore, just as it is unjust for the lender to demand a return with his capital guaranteed, it is equally unjust for the borrower not to return the principal to the lender.

What if the debtor defaults? Knowing that he CANNOT be obliged to pay anything more; will he not have a strong incentive to default? These and similar questions are the main focus of this paper. We will start discussing these questions from purely economic point of view. Morally speaking, a good Muslim (a good human being following any faith, for that matter) will fulfill his obligations. However, most human beings, including Muslims, have imperfect morality and they love money. Human history proves what the Holy Quran stated:

وَّتُحِبُّوْنَ الْمَالَ حُبًّا جَمًّا

"And you love wealth exceedingly". [89:20].

Admittedly, both creditors and debtors have a penchant to amassing wealth with as little pain as possible. Therefore, the question is that in a world of imperfect morals, how do we devise creditor-debtor relations to ensure justice to all concerned parties and to protect them from the greed of one another and the financial system and the global economy from disaster that results from violations of the basic principles of justice in the use of other peoples' money. In this paper we present some principles about debt creation which will hopefully lead to better creditor-debtor relations.

3. Six Principles for Better Creditor-Debtor Relations

The principles that we believe will help improving creditor-debtor relations are:

1. The Principle of 'Principals'
2. The Principle of 'Non-Principals'
3. The Principle of Restraint
4. The Principle of M-R Linkage
5. The Principle of Relief
6. The Principle of Transparency

Let us discuss them one by one.

1. The Principle of 'Principals':

A Western philosopher, Warren Buffett stated two Rules:

Rule 1: Preserve the Principal

Rule 2: When in doubt, see Rule #1

Justice demands that the creditor must get his principal back. If it emerged from a loan contract, the lender did him a favour (expecting a reward only from God) and if it emerged from a sales contract he earned a profit once but thereafter his money has the same status as that of a lender.

The guarantee of principal in debt instruments increases the supply of credit in the economy. It can open the door for risk-averse investors wishing to protect their investments while participating in gains from their investment. In modern finance, a parallel is a Principle Protected Note (PPN). A PPN as stated in Canadian Principal Protected Notes Regulation (SOR/2008-180) "means a financial instrument that is issued by an institution to an investor and that:

(a) provides for one or more payments to be made by the institution that is determined, in whole or in part, by reference to an index or reference point, including

(i) the market price of a security, commodity, investment fund or other financial instrument, and

(ii) the exchange rate between any two currencies; and

(b) provides that the principal amount that the institution is obligated to repay at or before the note's maturity is equal to or more than the total paid by the investor for the note.

The regulation states that "A principal protected note does not include a financial instrument that specifies that the interest or return on the instrument is solely determined on the basis of a fixed rate of interest or return or a variable rate of interest or return that is calculated from the institution's prime lending rate or bankers' acceptance rate".

We have quoted PPN as an example from modern financial instruments that comes close to Islamic instruments designed for risk-averse investors, e.g., *bay al-murabahah*. However, since the investor in a PPN does not share in the natural risk of investment, yet expects 'some' return, it violates the Islamic principle of "no pain, no gain".

The Principle of Principals that we are discussing is meant to ensure justice between the fund providers and fund users.

The holy Quran states:

وَاِنْ تُبْتُمْ فَلَكُمْ رُءُوْسُ اَمْوَالِكُمْ ۚ لَا تَظْلِمُوْنَ وَلَا تُظْلَمُوْنَ

"If you repent, you are entitled to your principal. Deal not unjustly nor shall you be dealt with unjustly"

This is part of verse [2:279] of the Holy Quran. The real significance of this statement will become apparent after we have discussed the second principal on our list.

The principle of principals is also established from the following Hadith:

قَالَ رَسُولُ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ: «الْعَوَرُ مُؤَدَّاةٌ، وَالْمِنْحَةُ مَرْدُودَةٌ، وَالدَّيْنُ مَقْضِيٌّ، وَالزَّعِيمُ غَارِمٌ»

[سنن أبي داود (٣/ ٢٩٦)]

"Anything given for benefitting from its usufruct is to be returned, a she-camel given temporarily for milking must be given back, **a debt must be discharged**, and one who stands surety is responsible to honor it". [Sunan Abu Dawood]

2. The Principle of 'Non-Principals'

While we believe that the principal amount due to any creditor must be protected, we also believe that the greed of creditors must also be restrained. Once a capital owner has earned a return having exposed his capital to risk, that should be the end of the deal. If an investor wants to earn continuing returns, he must continue to participate in the risk as well. So the real issue is not only bringing the interest rate down to zero, as a Keynesian policy prescription will like us to do. As a matter of principle, capital must earn a decent return in order for the economic growth to be sustainable. As a matter of principle also, the 'capitalist' must participate in risks which are part and parcel of everyday business. Insisting on the first principle and disregarding the second is a sure recipe for economic instability.

It is an established economic fact that in case of interest-based debts, the debtor in most cases returns to the creditor more than the principal through debt-service payments. The creditor does not share any risk, (except the risk of default, which is one of the issues under discussion). Claiming the total amount of debts (principal plus compounded interest) by the creditor without risk-sharing is unjust. Economic history tells us that this injustice causes pains and panics. In the full paper, we will analyse the financial crisis of 2008-2009 as a case study to show that the crisis was caused by interest-based lending and fuelled by attempts to force debtors to pay many times the principal amounts.

If the purpose is to establish justice, principals and non-principals must be treated differently. Non-Principals need not be guaranteed. Economics tells us that and history gives us that lesson. Now read the full verse of the Holy Quran [2:279]

فَاِنْ لَّمْ تَفْعَلُوْا فَاْذَنُوْا بِحَرْبٍ مِّنَ اللّٰهِ وَرَسُوْلِهٖ ۚ وَاِنْ تُبْتُمْ فَلَكُمْ رُءُوْسُ اَمْوَالِكُمْ ۚ لَا تَظْلِمُوْنَ وَلَا تُظْلَمُوْنَ

"But if you do not (give up interest), then listen to the declaration of war from Allah and His Messenger. However, if you repent, you are entitled to your principal. Deal not unjustly nor shall you be dealt with unjustly".[1]

[1] One of the famous translations of the Holy Quran (by Mohsin and Hilali), makes the point very clear. They interpret the verse as: "And if you do not do it, then take a notice of war from Allah and His Messenger but if you repent, you shall have your capital sums. Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums).

One of the prominent writers in Islamic finance, Umer Chapra, comments on this verse as follows:

> "The principal reason why the Quran has delivered such a harsh verdict against interest is that Islam wishes to establish an economic system where all forms of exploitation are eliminated, and particularly, the injustice perpetuated in form of the financier being assured of a positive return without doing any work or sharing in the risk, while the entrepreneur, in spite of management and hard work, is not assured of such a positive return. Islam wishes to establish justice between the financier and the entrepreneur"[2].

In the full paper, we will show that the greed of creditors has been the root cause of almost all financial crises. In the political field, they have been a source of international tensions even wars.

3. The Principle of Restraint

This is perhaps the most important of the six principles. Today we witness a debt explosion. It is worse than a 'cluster bomb explosion'. Its spread is wider; it dishonours, disables and kills more people. Worst, it enslaves people. In the full paper we will document this. For the time being suffice to draw attention to books/stories and terminology that has gained currency, e.g., "Debt is Slavery[3]"; "Debt is Virus[4]"; "Debt Bondage", "Debtor's Prison"; "Wage Garnishment", etc.

Let me, however, give you a couple of examples that debt forces people to make different decisions in their life. Consider a person Zaid, who has no debts to pay. He is laid off. He has to find a job. But his friend Bakr is also laid off. Unfortunately, he has a lot of debt to pay. He also have to find a job, but his need for a new job is much more urgent that that of Zaid. He will most likely accept a job that may not fit his career ambitions. Urgency of his debt instalments will force him to accept

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[2] Chapra, Umer (1985), p.64.

[3] Mihalik, Michael (2007), *Debt is Slavery and 9 other things I wish my Dad had taught me about money*, Seattle: Mist Publishing.

[4] Debt Virus: A Compelling Solution to the World's Debt Problems: Glenbridge Publishing
Jacques S. Jaikaran (1992); "Now Euro zone debt virus starts to overwhelm Italy", The Independent, Friday, April 13, 2012.

something that he does not like. Zaid also has to find a job, sure, but he can wait for something that he likes to come up.

Buying a house on mortgage has many pluses and minuses. We cannot discuss that here. The point that I wish to make is that with cash you have more options. You can negotiate a deal better. It is an established economic fact that people like to have money now than three years later. Put $25,000 on the table and you may get the house which had been bidden for $30,000. Your decision making and bargaining power is in your hands rather than your mortgage handler.

The time of sending your daughter to college comes. You start counting your pennies. You find that after making monthly payments out of your salary, there not enough left to pay for her education. You begin thinking that had you not bought that fluffy little cat for $500 and not spent $50 per month on cat food; had made do with your 21" perfect-running television instead of buying on credit that Wega 32" Trinitron; etc., you could perhaps spare so money for her education. However, it is too late now. Debt has snatched away your decision making and limited your options. You either go for another loan or delay sending her to college until she works to save enough money. It is not sure whether she will ever be able to complete her education.

Banks only tell us of their 'bad debts'. What I am trying to tell you is that *almost* all debt is bad? If "living beyond one's means'" is bad for an individual, it is equally bad for corporations and for governments. In resorting to debt finance, restraint is the rule for ALL, individuals, corporations and governments alike. 'Easy money' leads people to ignore the precautions that one must take even when taking debt is considered to serve some useful purpose or becomes inevitable. When must *never* forget that once incurred, debt must be discharged, except in very exceptional circumstances that we will mention under the next Principle. In the full paper, we will analyse some case studies of corporate and government debt to show that when debt reaches crisis proportions, which it invariably does if restraint is not exercised, attempts are made to 'sell-off' debt which creates bubbles. Sooner or later these bubbles burst and the resulting 'burns' wreck the debtors down to their souls. Do we not hear stories of people committing suicides due to their inability to pay debts?

The school of thought that advocates leveraging as a mean of increasing wealth often advocates using OPM (other people's money) to prosper. We are told that it is a smart to "use other people's money" to start a new business. You will get rich, no pains. This may sound great in theory. When you enter into practice, you find it to be quite different. The fact of the matter is that debt is not OPM. It is opium! Debt is habit-forming. Easy access to credit has some benefits, but once one lifts the guards, debt sneaks in like a snake, grows into a serpent that ultimately crushes one's bones. The worst part of it is that most, if not all, debt is unnecessary and can be avoided.

Hardly anyone will question the undesirability of what is known as 'gambling debt'. Yet the volume of such debt runs into billions. The average (gambling) debt is between $63,000 and $110,000[5] and is increasing. Just in one State, Wisconsin, the average gambling debt in 2011 more than doubled the previous record of $62,000[6]. Trend in other states of US and other Western countries is the same. Easy access to debt plays an important role in making a person pathologically addicted to debt. Let us now see some of the effects that such debt may lead to:

- Uncontrolled spending, the resulting debts and access to more money to gamble has a significant impact on health and can cause marital conflict, child neglect, poor work performance, multiple addictions, stress related physical ailments, crime and even suicide.[7]
- The rate of attempted suicide among compulsive gamblers is 200 times the national average.[8]
- Canada has up to 360 suicides a year by gambling addicts.[9]
- Twenty per cent of gamblers file for bankruptcy[10].
- Studies show that two out of three pathological gamblers commit crimes to pay off debt or to continue gambling. These include, among others, embezzlement, cheque forgery, stealing credit cards, tax evasion, fencing

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[5] CT Department of Mental Health, USA.

[6] Statistics compiled by the Wisconsin Council on Problem Gambling.

[7] Topp, Sawka, Room, Poulin, Single and Thompson, 1998.

[8] Arnie Wexler, the former executive director of the New Jersey Council on Compulsive Gambling and now head of a consulting firm that specializes in compulsive gambling.

[9] Canada Safety Council.

[10] Professor John Warren Kindt, John K. Palchak, Bankruptcy Developments Journal, volume 19, No. 1

stolen goods, insurance fraud, bookmaking, and/or employee theft, in some cases they involve violence and armed robbery.[11]

- The problems are not limited to individuals. "When you're dealing with one addict, you're dealing with 8-10 other people that get affected because of the addiction";[12] and the society in general suffers a lot. Society's cost per pathological gambler per year is $13,586. These costs include, crime, suicide, illness, business and employment costs, bankruptcy, social services, and direct government regulatory costs.[13]
- News paper stories relate many stories that due to gambling debt, many persons have forced their daughters and wives into immoral activities and in primitive societies even sold them.

Let us speak about a more ‘benign’ type of debt; credit card debt, whereby you can charge your dinner(s) and holidays to credit cards, not to speak of furniture, televisions and almost every consumer durable even pets. Wise people once used to say, “it is better to go without dinner the night before, than waking up in debt the morning after”. Now there are sales people who tell you that what they are offering you buy is part of the ‘normal’ way of life. So many people in your neighbourhood bought it and they are so happy that they did. You can easily afford and join the club of your ‘happy’ neighbours. One will tell you how you can pay for this timeshare plan to finance your ‘annual’ vacations in a splendid resort city. Other will tell you that trading in your old and outdated car with this new one with awful convenient features at sooo low interest rate is a such a wonderful buy that you will regret for years if you did not take it. Yet another will tell you, even if you already have two credit cards, you must buy this one. It will enhance your credit score. It is the best defence in emergencies, and who does’nt have emergencies.

Now among the 185 million card-holding U.S. consumers, the average person carries three bank-issued credit cards, four retail credit cards and one debit card, according to CardWeb.com. According to a survey by the American Bankers

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[11] Report of the National Council on Welfare, 1996, p.28.

[12] Ed Looney: the Council for Compulsive Gambling. March 21, 2006 Gambling at an All Time High www.family.org/cforum.

[13] Casino Watch.

Association and Dove Consulting, plastic payments now account for 53 percent of consumer purchases, compared to 43 percent in 1999. In 2011, credit card purchases crossed $2 trillion. The average credit card debt per card holder is estimated to be more than $6500 and it is one of the most expensive types of debt. Access to easy money, does not let people to make their calculations right. You are told that with credit card you can track your expenses more easily. That may be true. But what it makes easy is your past expenses. At the moment of making the expensive, you hardly think whether you can afford that $200 purchase or not. It is like putting your car on ‘cruise’, without having your foot on the brakes. Would that not put you to a big risk of crash?

The annualized rate of interest on credit card debt is more than 50%; (that’s why the credit card issuers are keener to create such debt than the consumers). Consumers do not realize that they pay higher prices using credit cards. Transaction fees that the merchants pay are ultimately added to the prices. Now merchants, lead by retailers like Wal-Mart, Sears and Safeway are set on lowering transaction fees. They're pushing for more debit card transactions which, pulled directly from a buyer's bank account, cost merchants much less.

Using debt causes people to spend more. They do not even notice many ‘hidden’ costs. A ‘small’ courier fee does not even enter into household budgeting. When you buy a new car on credit, you pay; say $1000 as down payment to the dealer. A ‘few’ bucks to the middleman and a ‘few hundred’ to the car care shop next door (most likely owned by the same dealership) to install some fantastic ‘optionals’. These dollars do not record the same way in household budget as groceries do. One of the biggest harms of debt is that people do not watch their spending like they do with out of pocket spending. More than two million households in US carry more than $20,000 in credit card debt.[14] Such huge consumer debts create tensions in households. Have we not heard stories of divorces taking place on not taking out enough for dinners and holidays? A recent study printed in the New York Times[15] showed that money fights are a predictor of divorce in marriage. A study, by Jeffrey Dew at Utah State University, tried to quantify that risk. His findings show that couples who reported

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[14] Business Insider, May 23, 2011.

[15] “Money Fights Predict Divorce Rates”, Catherine Rampell, *The New York Times*, May 4, 2012.

disagreeing about finance once a week were over 30 percent more likely to get divorced than couples who reported disagreeing about finances a few times a month.

Compare this to the Islamic position on debt. In an Islamic system, it is one of the five compulsory duties for a Muslim to undertake a journey to Mecca to perform pilgrimage once in one's life time. However, this *compulsory* duty is condoned for those who cannot afford to undertake this journey. If someone is in debt, payment of debt takes precedence over performing the pilgrimage.

In the area of corporate debt, the mention of the famous Modigliani-Miller Theorem (MMT) is inevitable. This theorem states that a firm's value is independent of how it is financed, i.e., leveraging does not affect the value of a firm. It only determines the distribution of cash flow from operations among creditors and owners. In the literature the MMT has been extensively studied. Even though, the results are not conclusive, the debt proliferators have conveniently ignored its main message. Without any conclusive evidence, they have relied on some partial and conflicting results to justify borrowing as heavily as their credit rating would allow. However, after the financial crisis of 2008-2009, there have been influential voices questioning the usefulness, or at least the level of, leveraging that we see today.

Let me quote here from the statements of an ongoing dialogue that started from the discussions at the Brookings Panel on Economic Activity 2010. At that forum Alan Greenspan's, the famous former Chairman of Federal Reserve of the United States (1987-2006, the second longest tenure in that position), presented a paper "The Crisis". He made a number of reform proposals in that paper. One of those was raising capital requirements and reducing leverage. However, he suggested that there are limits to how much we can do so. He was of the opinion that if we reduce leverage too much; financial intermediaries will be not be sufficiently profitable to remain viable. His proposals have generated a lot of debate. In brief, a large majority agrees on reducing the leverage and there are a number of influential voices which question his reservation on the limits to such reduction.

One such voice is that of Harvard economist Greg Mankiv which is worth quoting. He says, "Indeed, I think it is possible to imagine a bank with almost no leverage at all. Suppose we were to require banks to hold 100 percent reserves against demand deposits. And suppose that all bank loans had to be financed 100 percent with bank capital. A bank would, in essence, be a marriage of a super-safe money market mutual fund with an unlevered finance company. (This system is, I believe, similar to what is sometimes called "narrow banking"). It seems to me that a banking system operating under such strict regulations could well perform the crucial economic function of financial intermediation. No leverage would be required."

Another recent study by Anat R. Admati Peter M. DeMarzo, Paul Pfleiderer et.al of the Graduate School of Business, Stanford University, states:

"It is also incorrect to translate higher taxes paid by banks to a social cost. Policies that subsidize debt and indirectly penalize equity through taxes and implicit guarantees are distortive. Any desirable public subsidies to banks' activities should be given directly and not in ways that encourage leverage. And while debt's informational insensitivity may provide valuable liquidity, increased capital (and reduced leverage) can enhance this benefit. Finally, suggestions that high leverage serves a necessary disciplining role are based on inadequate theory lacking empirical support. We conclude that bank equity is not socially expensive, and that high leverage is not necessary for banks to perform all their socially valuable functions, including lending, deposit taking and issuing money-like securities. To the contrary, better capitalized banks suffer fewer distortions in lending decisions and would perform better. The fact that banks choose high leverage does not imply that this is socially optimal, and, except for government subsidies and viewed from an ex ante perspective, high leverage may not even be privately optimal for banks"[16].

I am sure these views will be contested. However, abstracting from the 'value of a firm' and considering the interests of the economy in general, we believe that if we factor in the above-mentioned risk factors (and not all have been mentioned), in contemporary world, they will far outweigh any benefit that could be gained by leveraging. Position Statement on the financial crisis of 2008-2009, in a gathering of more than 250 economists under the umbrella of the International Association for Islamic Economics, expressed a similar view: "The current crisis stemmed from excessive indebtedness resting on a relatively small base of equity and real wealth,

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[16] Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive", The Rock Center for Corporate Governance at Stanford University Working Paper Series No. 86, September, 2010.

‘the inverted debt pyramid’. A significant chunk of finance became merely the selling present for future money. Besides, poor regulations have encouraged over indebtedness. The Statement goes on to say that “Heavy reliance on debt intensifies economic instability, hence human insecurity, and generates significant negative economy-wide externalities, as painfully exemplified by the present crisis. The collapse of financial institutions inflicts harm upon shareholders, employees, and a host of innocent bystanders. Common economic sense suggests discouraging debt financing and encouraging benign alternatives. However, the exact opposite (e.g. preferential tax treatment of personal and corporate debt) is still the rule”[17].

The current situation wakes us up to some Ahadith of Prophet Muhammad (pbuh), related as a frequent prayer that he used to ask of Allah (SWT):

٥٤٨٨ - عَنْ عَبْدِ اللَّهِ بْنِ عَمْرٍو، أَنَّ رَسُولَ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ، كَانَ يَدْعُو بِهَؤُلَاءِ الْكَلِمَاتِ: «اللَّهُمَّ إِنِّي أَعُوذُ بِكَ مِنْ غَلَبَةِ الدَّيْنِ، وَشَمَاتَةِ الْأَعْدَاءِ»[سنن النسائي (٨/ ٢٦٨)]

Prophet (PBUH) used to frequently pray: “O Allah! I seek YOUR refuge from being overcome by debts and from anything that would make my enemies happy.”

٦٣٦٩ - سَمِعْتُ أَنَسَ بْنَ مَالِكٍ، قَالَ: كَانَ النَّبِيُّ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ يَقُولُ: «اللَّهُمَّ إِنِّي أَعُوذُ بِكَ مِنَ الهَمِّ وَالحَزَنِ، وَالعَجْزِ وَالكَسَلِ، وَالجُبْنِ وَالبُخْلِ، وَضَلَعِ الدَّيْنِ، وَغَلَبَةِ الرِّجَالِ» [صحيح البخاري (٨/ ٧٩)]

Prophet (PBUH) used to frequently pray: “O Allah! I seek YOUR refuge from distress and sorrow, from helplessness and laziness, from miserliness and cowardice, from being heavily in debt and from being prevailed over by men "

It is well-known that the prayers of the Prophet (PBUH) were an important way of teaching people what is desirable and what is not. The importance of the two Arabic words used here, i.e., ‘غَلَبَةِ الدَّيْنِ’ and ‘ضَلَعِ الدَّيْنِ’ needs to be noted. The first refers to a situation where one is overcome by debt. In other words his freedom of action becomes impaired. This we notice in case of individual, corporate and sovereign debt today. In many ways, the debtor is under creditor’s control.

The second word ‘ضَلَعِ الدَّيْنِ’ indicates a situation where the debtor feels as if he is in shackles. He feels and suffers the pain but is stuck and sandwiched. Again we

[17] Economic Solutions from Islamic Finance: Position Statement of the International Association for Islamic Economics, Issued at the occasion of the Eight International Conference on Islamic Economics, Qatar, November, 2011.

notice that this is the condition that the debtors find them in when debt becomes excessive.

4. The Principle of M-R Linkage

If there is a grain of truth in the argument that leveraging can be a mean to increasing wealth, it *must* necessarily be qualified. Money creation, whether through borrowing from the central bank by a government (running the printing machine) or through credit creation by commercial banks must be linked to the real sector. In the words of the Position Statement of the International Association for Islamic Economics, "to build a sustainable system, debt must grow in tandem with real (as opposed to financial) wealth; leverage must be capped by productivity potentials. This allows for real wealth to grow without being hurdled with too heavy debt". One of the most prominent Islamic economists, Khurshid Ahmad explains the issue more clearly:

> "The delink between money and production activity has led to the emergence of two parallel economies, a money economy and other the real physical economy. Money that was an instrument of exchange and a measure of value became the sole embodiment of value. An instrument that was designed to facilitate exchange and production, became an object in itself. Real economy slumbered but financial economy expanded beyond all limits, enriching those alone who were engaged in the business of finance. This created a fiduciary world of its own. Money generating more Money without producing Goods and Services in the economy, without increasing the stock and flow of assets in the society. In this new fangled economic order money became the main player as well as the prize. The process of real value-addition in the economy has been slowed if not disrupted. Money and creation of fiat money became the real game, resulting in the creation of wealth that only produces billionaires without adding much to the well being of the people. The result is that the system has succeeded in creating an economy wherein presently while the world GDP in current prices is around $60 trillion, we have an ever expanding realm of fiduciary money, wherein annual trade in derivatives now exceeds $900 trillion. In this game the real players and also beneficiaries are only a few thousand pseudo-investors while the whole global economy is at the suffering end. The same is true of

the foreign exchange markets where daily trade in foreign currencies is fifty times more than the volume of daily movement of trade and tourists. The present day vulnerability and instability of the capitalistic economy owes much to this fatal delink."[18]

5. The Principle of Relief

As stated above; once incurred, debt must be discharged, except in very exceptional circumstances. In general, creditors' right to get their principals back must be protected, but they cannot go beyond a certain limits, e.g. enslaving the debtors. An important distinction must also be made between a "delinquent debtor" and a "distressed debtor". The former is a debtor who has enough assets or fairly certain flows of future income or wealth to discharge his debts. Such debtor must be dealt with strictly. Later in the paper, we will mention legal measures to do that. The latter is a debtor who despite his willingness to pay and sincere efforts made to discharge his debt, is not in a position to honour his payment liabilities. Such a debtor deserves to be provided relief.

This principle is well-established in Islamic law. Here I quote two *nusus* (Islamic texts). Details will be discussed in the full paper.

1. "And if the debtor is going through a hard time (has no money), then grant him time till it is easy for him to repay, but if you remit it by way of charity, that is better for you if you did but know." [Al Quran 2:280]
2. "During the time of Prophet (PBUH), the fruits of one Companion's garden got destroyed due which his debts piled up. Prophet (PBUH) asked the Companions to collect funds to help him pay his debts. They did, but the collection was not enough to pay the debts. Upon that he told the creditors "take this and you do not have any more claim against him." [Sahih Muslim]

Some important points that emerge from the Hadith quoted above need to be noted. These are:

1. The right of the creditor to his principal was recognized [Principle of principals].

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[18] Ahmad, Khurshid, "Global Economic Crisis and the Role of Islamic Economics", IDB Prize Laureate Lecture, April 21, 2012.

2. All possible efforts were made to discharge the debt in full. For this purpose, even charity was collected.
3. Having done that, when ‘available’ money was not enough, debt write-off was granted.

For a distressed debtor, there are even more measures in Islamic system. These are:

A. Hawalah:

This is voluntary and charitable act where someone undertakes to pay the debts of another person. No fee, compensation or benefit can accrue to the one taking up this responsibility[19]. In this regard it is stated in Sahih Bukhari that Prophet (pbuh) said, "Procrastination (delay) in paying debts by a wealthy person is injustice. So, if your debt is transferred from your debtor to a rich person, you should agree."

B. Share of gharimeen (those in debt) in zakah

As is well-known, zakah is a compulsory levy imposed by God on every Muslim who has a net-worth above a minimum level called ‘nisab’. Of the five ‘pillars of Islam’, zakah is the second one. It is an earmarked levy. Its beneficiaries are fixed who are grouped in eight categories. One of these eight relates to those who have debts that they are unable to pay. In this way, the rich people in the whole society contribute to payment of debts, in case of distress.

C. Given enough available resources, the state is responsible to discharge the debt. Prophet stated (as a head of the state) that:

«أَنَا أَوْلَى بِالْمُؤْمِنِينَ مِنْ أَنْفُسِهِمْ، فَمَنْ تُوُفِّيَ مِنَ المُؤْمِنِينَ فَتَرَكَ دَيْنًا، فَعَلَيَّ قَضَاؤُهُ، وَمَنْ تَرَكَ مَالًا فَلِوَرَثَتِهِ»
[صحيح البخاري (٣/ ٩٧)]

"I am more rightful than other believers to be the guardian of the believers, so if a Muslim dies while in debt, I am responsible for the repayment of his debt, and whoever leaves wealth (after his death) it will belong to his heirs. " [Sahih Bukhari]

[19] This may not be confused with ‘money transfer’, whereby an institution transfers money from one place to another against a fee. Charging such a fee is permissible.

In contemporary law there are some parallel measures including write-offs, debtor protection laws, bankruptcy/insolvency acts and bailouts. In most legal jurisdictions there are bankruptcy and/or insolvency laws. These are designed to settle creditor-debtor disputes in amicable manners. In most such laws, some sort of relief to debtors is built in. For example, the Canadian Insolvency Act (1986), there is a provision called “A Company Voluntary Arrangement (CVA)”. This is a legal agreement between a company and its creditors, based on paying fixed monthly payments by the company to its creditors, the total amount of payments being less than the actual total debt. At the end of the agreed term, and given regular payment of agreed installments, the remaining debt is written-off.

Unfortunately, these provisions are often misused. Bankruptcy fraud is so rampant that calls for reform are loud and clear. Such fraud may take the form of concealment of assets by the debtors, multiple bankruptcy filings in different legal jurisdictions, intentional inaccuracies in bankruptcy petitions in order to prolong the proceedings to the disadvantage of creditors and similar other acts of camouflaging. In the full paper we will analyze some case studies of bankruptcies declared in recent years.

Bailouts like the one of Fannie Mae and Freddie Mac raise the expectations of future bailouts. That would lend support to the “too big to fail” theory. That would start a vicious cycle. The corporations will be tempted to delay putting their house in order in time to avoid eventual collapse. The creditors will get deeper in the abyss by advancing further loans to them considering them safe. The financial institutions will take a happy ride on their low cost debt to leverage even more. It is an established fact that enterprises like Fannie Mae and Freddie Mac expanded substantially their holdings of subprime mortgages, due to misguided public policy. Tax payers were the ultimate losers.

As a practical example of the principle of relief in contemporary world, we would like to state that if this principle was adhered to, the ‘debt forgiveness’ initiative of the United Nations for the poor indebted countries would not have faced such stiff resistance from the creditor nations and institutions. Such debt forgiven is called for more than one reason. Firstly, these countries in general have paid more than the principal amount through debt service payments. Secondly, the creditor nations have taken a good share back through conditional ties of importing from them, high price consultancies and such other measures[20]. In many cases it involved exports of sub-standard, even obsolete products by the creditors. Thirdly, such debt was in most cases used for reasons other than it was granted for. This was done with the knowledge, even connivance of the creditors. This was done to gain political influence and for the protection of creditor national interests. Fourthly, such debt is known to have involved huge kick-backs on both debtors and creditors sides. This is criminal activity, and in case of sovereign debt it is crime against the people of debtor nations. Fifthly, the instability created by this debt, threatens the entire global economy.

6. The Principle of Transparency

If the greed of creditors is insatiable, that of debtors is obsessive. 'Debt Handlers' make billions out of this cheating game. Therefore, the sixth principle is very important. Transparency will benefit both sides. It MUST be ensured that relief is not misused. It requires strict laws to punish unscrupulous debtors, especially those who fake being broke. This principal is also an established Islamic value. In the Annexure on *nusus*, we will include some verses and Ahadith in this respect. Here, we quote just on Hadith:

قَالَ رَسُولُ اللهِ صَلَّى الله عَلَيْهِ وسَلَّمَ : لَيْسَ مِنَّا مَنْ غَشَّ

"One who cheats, does not belong to the community of Muslims." [Sunan Abu Dawood]

4. Legal Measures for Protecting the Rights of Creditors

Creditor rights deserve to be protected by the force of law. However, while laws can help, ethics is more important. We will talk about ethical measures later. First, let us see how far the legal measures can take us. In Table 1, we present two packages of legislation. Some pieces are explicitly shown to be common between the two. Others may have parallels. The point we wish to make is that long before contemporary laws addressed these issues, Islamic laws had incarnated several measures to protect the fair rights of the creditors.

[20] It may be pertinent to note that such borrowing, in addition to violating the Islamic prohibition of riba, also violates another Islamic prohibition, that is, loan cannot be combined with trade in a contract.

Table 1

Legal Measures for the Protection of the Rights of Creditors

Package 1	Package 2
1. Creditors are ensured Annual Compound Interest Payments in addition to the principal amount of the debt.	1. Creditors cannot charge anything more than the principle amount of the debt.
2. They can take collateral which they can sell in case of default.	2. They can take collateral which they can sell in case of default
3. If the debtor declares bankruptcy, all creditors will share his assets according to some predetermined priorities.	3. If the debtor declares bankruptcy, all creditors will share his assets proportionately
4. Delinquent debtor can be jailed (given physical punishment by a Judge).	4. Delinquent debtor can be jailed (given physical punishment by a Judge).
5. A lien can be put on his assets.	5. Delinquent debtors will be stopped to use their assets for buying or selling, gifting, transferring through will or in any other manner until they pay their debts.
	6. Delinquent debtors will be declared “Persona non Grata”.
	7. Names of delinquent debtors will be published every month in the Wall Street Journal.
	8. Names of delinquent debtors will be included in the "Exit Control List".
	9. Creditors will have the FIRST claim over the inheritance of the debtor.

Source: Compiled by the author.

Before going into a discussion of these measures, let me state that some of these measures apply to only individuals, but most apply to corporations as well either in the same form or in a somewhat modified form. However, it is pertinent to note that most bankruptcy filings are made by individuals. As shown in Table 2, generally speaking, non-business bankruptcy filings are more than 96% of the total bankruptcy filings in the US.

Table 2

US Bankruptcy Filings (2006-11)

Year (1)	Totals Filings (2)	Business Filings (3)	Non-Business Filings (4)	Column (4) as % of Column (2) (5)
2006	617,660	19,695	597,965	96.8
2007	850,912	28,322	822,590	96.7
2008	1,117,771	43,546	1,074,225	96.1
2009	1,473,675	60,837	1,412,838	95.9
2010	1,593,081	56,282	1,536,799	96.5
2011	1,410,653	47,806	1,362,847	96.6

Source: American Bankruptcy Institute

A Digression on Sovereign Debt:

The case of sovereign debt is different and these legal measures cannot apply to governments. In case of government debt discipline and governance structures are most important. These can be, and in many cases have been, legislated. The problems that arise in that area emerge from flouting those laws. It is largely a political affair. In dictatorial regimes, the rulers, in general, have been exploiting their people throughout the human history. In democracies, voters can theoretically ‘punish’ and discipline the rulers. History, however, tells us that it is more in theory than in practice.

In the full paper, we will discuss the issue of public debt in more detail, but it may be pointed out that the six principles given in this paper equally apply to governments as they do to individuals and corporations. It is interesting to note that in the Corruption Perceptions Index (CPI), prepared annually by the Transparency International, many Eurozone countries, particularly those affected by the financial crisis, including Greece and Italy, are doing worse and worse. Many of the lowest-scoring European countries are those hardest hit by the financial and debt crises.

Besides tackling corruption, the need for fiscal reform is a major issue in US, Europe and other countries around the globe. Reducing budget deficits is the most important issue in elections in the US and European countries including France. Political parties; Right, Left and Center, all agree on the need to reduce budget deficits in the shortest period of time. French President Nicolas Sarcozi, seeking re-election has gone to the extent to promise that he intended to insert the "balanced budget" rule into the French constitution, subject to approval by French electorate in a referendum on the issue. Even though, possibilities of budget deficits are not completely ruled out, there are cries for austerity measures and fiscal discipline across the Atlantic Ocean. Talking of the recent Europe’s fiscal pact, German Chancellor, Ms Merkel has said that the pact, which binds Eurozone countries to keeping their deficits below 3pc, was "non-negotiable" and would "last forever". Across the Atlantic, worried about the reaction of the electorate who consider budget deficit to be their top worry, both front runners, Barak Obama and Mitt Romney, are trying to lure voters promising to cut the Federal deficit, though through different plans. They were forced into this by a public outcry after Standard & Poor’s downgraded the US credit rating and raised the fears that the United States may default on its obligations. If that can happen to a “currency issuer”, who pockets billions of dollars annually in ‘seigniorage’, simply by running the printing press, the other countries are much more vulnerable.

Election promises aside, balancing the budget in present situations of these countries is easier said than done. It requires austerity measures that the electorate cannot digest after they have got used to public supports. Dissenting voices are already being heard, because of political expediencies, rather than economic fundamentals. From an economic point of view budget deficits, *except in very special cases and for short periods of time,* are bad economics. However, as we hinted above, the shackles of debt once on, are not easy to break out from. Strong lobbies are created as is evident in most Western countries. American President, and the author of ‘United States Bill of Rights’, James Madison, once said, “I go on the principle that a public debt is a public curse, and in a Republican Government a greater curse than any other”. Today the US national debt stands at $15.7 trillion. The Democrats hold Republicans responsible for the massive increase and blame them to be big ‘spenders’, but the fact remains that total Federal debt has grown by about US$4.6-trillion under Obama’s regime. Everyone knows it has not grown for economic reasons. The average American citizen, who shares around US$ 50,000 in the national debt is crying, “It is the War, stupid! Not the economy”. The English wisdom states that, “Nip the evil in the bud”. Therefore, the principle of restraint is perhaps the most important principle to be adhered to, if later problems are to be avoided.

Reverting to the legal measures available to protect the genuine interests of creditors, let me take the nine measures given in Package 2 and give some details with respect to their roots in the Islamic system. Out of the nine measures I included in Package 2, the first three are well known as basics of Islamic finance. I do not need to make any comment. The fourth and fifth are derived from the following Hadith:

عَنْ عَمْرِو بْنِ الشَّرِيدِ، عَنْ أَبِيهِ، عَنْ رَسُولِ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ قَالَ: «لَيُّ الْوَاجِدِ يُحِلُّ عِرْضَهُ، وَعُقُوبَتَهُ»
[سنن أبي داود (٣٦٢٨)]

“Delaying payment of debts by one who has the means to discharge his debts makes it permissible to dishonor and punish him”

The Hadith permits two things over the delinquent debtor: (i) dishonoring him and (ii) punishing him. With respect to the first one there is consensus that such a debtor can be punished through imprisonment. Whether or not he can be punished through financial penalty is a controversial issue. The fatwa so far is that he cannot be but I have some points that I will discuss later.

Secondly, the Hadith makes it permissible to discredit the delinquent debtor in public. Now in modern times if this is done through putting their names on media and internet, you can imagine how effective this measure would be. The corporations will know that if their names appear in such a list, their share prices will sharply decline and they will not get additional funding since their credit rating will also decline. The individual debtors will also suffer a decline in their credit rating. Therefore, such a measure will be a strong inducement for them to pay up.

The sixth measure allows that the delinquent debtor can be prohibited from travelling. In this respect there is some detail. The opinion of Ibn Qudama quoted below is very revealing:

....وَجُمْلَةُ ذَلِكَ أَنَّ مَنْ عَلَيْهِ دَيْنٌ إذَا أَرَادَ السَّفَرَ، وَأَرَادَ غَرِيمُهُ مَنْعَهُ، نَظَرْنَا؛ فَإِنْ كَانَ مَحَلُّ الدَّيْنِ قَبْلَ مَحَلِّ قُدُومِهِ مِنْ السَّفَرِ، مِثْلُ أَنْ يَكُونَ سَفَرُهُ إلَى الْحَجِّ لَا يَقْدَمُ إلَّا فِي صَفَرٍ، وَدَيْنُهُ يَحِلُّ فِي الْمُحَرَّمِ أَوْ ذِي الْحِجَّةِ، فَلَهُ مَنْعُهُ مِنْ السَّفَرِ؛ لِأَنَّ عَلَيْهِ ضَرَرًا فِي تَأْخِيرِ حَقِّهِ عَنْ مَحَلِّهِ .فَإِنْ أَقَامَ ضَمِينًا مَلِيئًا، أَوْ دَفَعَ رَهْنًا يَفِي بِالدَّيْنِ عِنْدَ الْمَحَلِّ، فَلَهُ السَّفَرُ؛ لِأَنَّ الضَّرَرَ يَزُولُ بِذَلِكَ. وَأَمَّا إنْ كَانَ الدَّيْنُ لَا يَحِلُّ إلَّا بَعْدَ مَحَلِّ السَّفَرِ، مِثْل أَنْ يَكُونَ مَحَلُّهُ فِي رَبِيعٍ،

وَقُدُومُهُ فِي صَفَرٍ، نَظَرْنَا؛ فَإِنْ كَانَ سَفَرُهُ إلَى الْجِهَادِ، فَلَهُ مَنْعُهُ إلَّا بِضَمِينٍ أَوْ رَهْنٍ؛ لِأَنَّهُ سَفَرٌ يَتَعَرَّضُ فِيهِ لِلشَّهَادَةِ، وَذَهَابِ النَّفْسِ، فَلَا يَأْمَنُ فَوَاتَ الْحَقِّ

المغني لابن قدامة (٤/ ٣٤٢)

"… If any debtor intends to go on an outstation journey and his creditor wants to stop him from travelling, then in our view if the debt falls due before his expected date of return, for example, he intends to travel for Haj and he will not return before the month of Safar (2nd month in Hijrah Calendar) whereas his debt falls due in Muharram (1st month in Hijrah Calendar or DHulhijja, i.e., the month before), then the creditor can stop him from travelling because he will suffer due to delay in payment. However, if someone rich enough to pay the debt stands surety or the debtor tenders a collateral that would cover the amount of debt, then he can proceed on his journey because the damage (to the creditor) will thus be covered. If the debt does not fall due until the expected date of his return; for example, the due date is in Rabi (3rd month in Hijrah Calendar) and his expected date is in Safar, then he can be stopped from travelling if his journey is for *jihad* (Islamic expedition for fighting enemies), unless someone stands surety or he tenders a collateral. This is so because there is a possibility that he may be killed in the fighting, and the creditor's right will not have been protected."

This passage has a number of very important points relevant to our subject. We will discuss them in the full paper. Here I have quoted it as a support for the sixth measure in my proposed list i.e., putting the names in the "Exit Control List". I think such a measure will be will be very effective. It is pertinent to note that many countries have regulations similar to this. Among them are GCC countries. Reports confirm that a travel ban on delinquent debtors has helped the banks and other companies to recover their debts. It is interesting to note that Australia has a somewhat similar law. In Australia, tax officers can issue a Departure Prohibition Orders (DPO) against persons having unpaid tax (i.e., debt to treasury).

The seventh measure that the delinquent debtor can be declared as "Persona Non Grata" is based on the opinion of a majority of Islamic scholars who argue that Prophet Muhammad (pbuh) declared delinquency as *zulm* (injustice)[21]. Now *zulm* is a

[21] Relevant Hadith along with some other *nusus* will given in an Annexure to be attached to the final paper.

major sin (*kabirah*). Anyone who commits a *kabirah* sin is *fasiq* (sinful or abominable person). A *fasiq* is persona non grata in Islamic society so much so that according to the opinion of the majority of Islamic scholars even his testimony is not accepted in an Islamic court.

The eighth measure in my suggested Package is derived from the following Hadith:

Imam Hakim and Dar Qutni report that Prophet (pbuh) imposed *hajr* on Hazrat Muaz and paid off his debts by selling his property

Imposition of *hajr* means suspension of all rights of debtor with respect to his property, including buying and selling, transfer by gift or will, and even making charity.

Similar measures exist in many legal jurisdictions today. For example, in US and most common law countries a creditor can put a lien (through courts) on the property of the debtor. It involves a passive right to retain (but not sell) property until the debt is discharged. In some jurisdictions other encumbrances on the use of the property under lien can also be imposed. In case of employees bearing debts (of government or companies), in many legal jurisdiction the creditor can obtain a court order whereby regular deductions, called 'wage garnishment', will be made directly through the payroll and passed on to the creditor.

The ninth measure implies two things: (i) That payment of debt has priority over implementation of will. This is based on the following Hadith

عَنْ عَلِيٍّ، «أَنَّ النَّبِيَّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَضَى بِالدَّيْنِ قَبْلَ الوَصِيَّةِ»، وَأَنْتُمْ تَقْرَءُونَ الوَصِيَّةَ قَبْلَ الدَّيْنِ
[سنن الترمذي (٤/ ٤٣٥)]

Prophet (pbuh) said, "Pay debts (of the deceased) before implementing his will, though (in the verses of Holy Quran you read) implementation of will is mentioned before payment of debts. [Sunan al Tirmizi]"[22]

(ii) Debts must be settled before inheritance is distributed. There are many verses in the Holy Quran that make it compulsory. One of those is:

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[22] Interpreters of the Holy Quran have explained that there is no contradiction between this Hadith and the order mentioned in the verses of the Holy Quran. There it is a stylistic matter. The emphasis is the same as mentioned in this Hadith.

يُوْصِيْكُمُ اللّٰهُ فِيْٓ اَوْلَادِكُمْ ۤ لِلذَّكَرِ مِثْلُ حَظِّ الْاُنْثَيَيْنِ ۚ فَاِنْ كُنَّ نِسَاۤءً فَوْقَ اثْنَتَيْنِ فَلَهُنَّ ثُلُثَا مَا تَرَكَ ۚ وَاِنْ كَانَتْ وَاحِدَةً
فَلَهَا النِّصْفُ ۗ وَلِاَبَوَيْهِ لِكُلِّ وَاحِدٍ مِّنْهُمَا السُّدُسُ مِمَّا تَرَكَ اِنْ كَانَ لَهٗ وَلَدٌ ۚ فَاِنْ لَّمْ يَكُنْ لَّهٗ وَلَدٌ وَّوَرِثَهٗٓ اَبَوٰهُ
فَلِاُمِّهِ الثُّلُثُ ۚ فَاِنْ كَانَ لَهٗٓ اِخْوَةٌ فَلِاُمِّهِ السُّدُسُ مِنْۢ بَعْدِ وَصِيَّةٍ يُّوْصِيْ بِهَآ اَوْ دَيْنٍ ۗ اٰبَاۤؤُكُمْ وَاَبْنَاۤؤُكُمْ لَا تَدْرُوْنَ اَيُّهُمْ
اَقْرَبُ لَكُمْ نَفْعًا ۗ فَرِيْضَةً مِّنَ اللّٰهِ ۗ اِنَّ اللّٰهَ كَانَ عَلِيْمًا حَكِيْمًا

“Allah commands you as regards your children's (inheritance); to the male, a portion equal to that of two females; if (there are) only daughters, two or more, their share is two thirds of the inheritance; if only one, her share is half. For parents, a sixth share of inheritance to each if the deceased left children; if no children and the parents are the (only) heirs, the mother has a third; if the deceased left brothers or (sisters), the mother has a sixth. (The distribution in all cases is) after the payment of legacies he may have bequeathed or debts. You know not which of them, whether your parents or your children, are nearest to you in benefit, (these fixed shares) are ordained by Allah. And Allah is Ever All Knower, All Wise.” [Al-Quran 4:11]

5. Ethical Measures Relating to Debt and Creditor-Debtor Relations

Islamic system there is four layers of means to achieve any objective. These are:

1. Moral Exhortation
2. Legal Injunctions
3. Role of the Society
4. Role of the State

We have talked about the last three in one way or the other. Last, but not the least, moral values play a very important role. Morals take time to ingrain, but once entrenched they are a much stronger force for achieving desired goals. Let me therefore, present Islamic morals that will set a proper role and attitude towards debt and help creating smoother relations between the debtors and creditors. There are three kinds of such measures:

A. Measures Encouraging Payment of Debts
B. Measures Discouraging Non-Payment of debts
C. Measures Discouraging Overburdening Debt

Let us take them one by one:

A. Measures Encouraging Payment of Debts

Firstly, debtors are morally motivated to pay their debts. Some nusus in this respect are quoted below:

(i) In Surah Al-Nisa Ayah 58, Allah (SWT) orders as follows:

اِنَّ اللّٰهَ يَاْمُرُكُمْ اَنْ تُؤَدُّوا الْاَمٰنٰتِ اِلٰٓى اَهْلِهَا ۙ وَاِذَا حَكَمْتُمْ بَيْنَ النَّاسِ اَنْ تَحْكُمُوْا بِالْعَدْلِ ۗ اِنَّ اللّٰهَ نِعِمَّا يَعِظُكُمْ بِهٖ ۗ اِنَّ اللّٰهَ كَانَ سَمِيْعًاۢ بَصِيْرًا

Verily!Allah commands that you should render back the trusts to those, to whom they are due; and that when you judge between men, you judge with justice. Verily, how excellent is the teaching which He (Allah) gives you! Verily Allah is ever Hearing, ever Beholding.

(ii) Preparing Oneself to Pay Debts:

The following Hadith of Prophet (pbuh) sets an example for the debtors:

قَالَ رَسُولُ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ: «لَوْ كَانَ لِي مِثْلُ أُحُدٍ ذَهَبًا مَا يَسُرُّنِي أَنْ لاَ يَمُرَّ عَلَيَّ ثَلاَثٌ، وَعِنْدِي مِنْهُ شَيْءٌ إِلَّا شَيْءٌ أُرْصِدُهُ لِدَيْنٍ »[صحيح البخاري (٢٣٨٩)]

Prophet (pbuh) said, “ If I had gold equal to the weight of mountain uhad, I would not like that anything from that remains with me for three days, **except something that I would save to pay off debts**.”

(iii) Prophet (pbuh) used to refuse leading the funeral prayer of anyone who had debts and had nothing left to settle them.

عَنْ سَلَمَةَ بْنِ الأَكْوَعِ رَضِيَ اللَّهُ عَنْهُ، قَالَ: كُنَّا جُلُوسًا عِنْدَ النَّبِيِّ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ، إِذْ أُتِيَ بِجَنَازَةٍ، فَقَالُوا: صَلِّ عَلَيْهَا، فَقَالَ: «هَلْ عَلَيْهِ دَيْنٌ؟»، قَالُوا: لاَ، قَالَ: «فَهَلْ تَرَكَ شَيْئًا؟ »، قَالُوا: لاَ، فَصَلَّى عَلَيْهِ، ثُمَّ أُتِيَ بِجَنَازَةٍ أُخْرَى، فَقَالُوا: يَا رَسُولَ اللَّهِ، صَلِّ عَلَيْهَا، قَالَ: «هَلْ عَلَيْهِ دَيْنٌ؟ » قِيلَ: نَعَمْ، قَالَ: «فَهَلْ تَرَكَ شَيْئًا؟ »، قَالُوا: ثَلاَثَةَ دَنَانِيرَ، فَصَلَّى عَلَيْهَا، ثُمَّ أُتِيَ بِالثَّالِثَةِ، فَقَالُوا: صَلِّ عَلَيْهَا، قَالَ: «هَلْ تَرَكَ شَيْئًا؟ »، قَالُوا: لاَ، قَالَ: «فَهَلْ عَلَيْهِ دَيْنٌ؟»، قَالُوا: ثَلاَثَةُ دَنَانِيرَ، قَالَ: «صَلُّوا عَلَى صَاحِبِكُمْ » [صحيح البخاري (٢٢٨٩)]

This is a story related by Salam bin Akoo, telling an incidence when three funerals of his companions were brought to Prophet (pbuh) requesting him to lead the funeral prayers. Each time he asked, did he left an unpaid debt? If the answer was in the affirmative, he asked a second question, did he left enough bequest to pay off the debt, if the answer/evidence was affirmative, he would lead the prayer. Otherwise, he would tell his companions to pray on their own.

Now we know that Prophet (pbuh) loved his companions beyond our imagination. Not leading funeral prayers for anyone is an indication how seriously he disliked **NOT** paying one’s debts.

(iv) Reward for those who Pay Debts in Nice Manner which first and foremost includes payment on time.

قَالَ رَسُولِ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ: « إِنَّ خِيَارَكُمْ أَحْسَنُكُمْ قَضَاءً »

[صحيح البخاري (٢٣٠٥) صحيح مسلم (١٦٠١)]

Prophet (pbuh) said, "The best among you is the one who is best in payment of his debts"

(v) Personal Practice of the Prophet (pbuh).

Prophet (pbuh) used to pay ASAP. And pay more than borrowed almost always.

There are too many incidences of this practice. One of these in brief was:

عَنْ جَابِرِ بْنِ عَبْدِ اللَّهِ، قَالَ: «كَانَ لِي عَلَيْهِ دَيْنٌ فَقَضَانِي وَزَادَنِي» [صحيح البخاري (٤٤٣) صحيح مسلم (٧١٥)]

Jabir relates that Prophet (pbuh) owed him a debt. When he demanded it from him, Prophet gave it to him and gave more.

Many more examples of this behavior of Prophet (pbuh) will be given in the full paper.

(B) Measures Discouraging Non-Payment of Debts

We must remind the readers that unlike conventional system, Islam makes a distinction between two types of debtors: (i) Those, who are in real difficulties and despite their best efforts they are unable to pay. (ii) Delinquent Debtors. For the first category, Islam encourages to take a lenient attitude while the second category is dealt with strict measures.

Here we are concerned with the second category. Let us see the Islamic position and measures for this category of debtors. There are many *nusus* on this. We will give them in the Annexure on Nusus to be attached to the full paper. Here we quote just one. That alone is sufficient to describe how seriously Islam takes the matter of pay back one's debts.

عَنْ مُحَمَّدِ بْنِ جَحْشٍ قَالَ: كُنَّا جُلُوسًا عِنْدَ رَسُولِ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ فَرَفَعَ رَأْسَهُ إِلَى السَّمَاءِ، ثُمَّ وَضَعَ رَاحَتَهُ عَلَى جَبْهَتِهِ، ثُمَّ قَالَ: «سُبْحَانَ اللَّهِ، مَاذَا نُزِّلَ مِنَ التَّشْدِيدِ» فَسَكَتْنَا وَفَزِعْنَا، فَلَمَّا كَانَ مِنَ الْغَدِ، سَأَلْتُهُ: يَا رَسُولَ اللَّهِ، مَا هَذَا التَّشْدِيدُ الَّذِي نُزِّلَ؟ فَقَالَ: «وَالَّذِي نَفْسِي بِيَدِهِ، لَوْ أَنَّ رَجُلًا قُتِلَ فِي سَبِيلِ اللَّهِ ثُمَّ أُحْيِيَ، ثُمَّ قُتِلَ ثُمَّ أُحْيِيَ، ثُمَّ قُتِلَ وَعَلَيْهِ دَيْنٌ، مَا دَخَلَ الْجَنَّةَ حَتَّى يُقْضَى عَنْهُ دَيْنُهُ» [سنن النسائي (٤٦٨٤)]

In this incident the companion relates that once they were sitting with the Prophet (pbuh). He raised his head towards the sky and then said "…what a strict warning has been revealed to me.” Companions kept quite because they were stunned due to revelation of a strict warning. Next day they asked about it. The Prophet (pbuh) swore by God and said, “if a person was killed in the path of Allah, then raised again and killed again, then raised again and killed again, and he had unpaid debt, he will not enter paradise unless his debt is paid off.”

6. The Issue of Financial Penalty on Delinquent Debtors

In the beginning of the paper, we raised the issue that a delinquent debtor, knowing that he cannot be obliged to pay anything more will have a strong incentive to default. For Islamic banking, where a lot of transactions result in debts owed to the banks in future, this creates a big problem. Since they cannot charge anything more once the debt has been created, can they impose a financial penalty to recover the damage caused to them due to delay in payments?

The current religious verdict is that it is not allowed. The argument is that once something becomes debt, the creditor cannot take anything from the debtor that he will benefit from. Therefore, even those who allow putting penalty on delinquent debtor make it conditional that the money is given to charity. That does solve part of the problem, that is, the incentive to default is removed. But what about the damage caused to the banks. The suggestion that they claim damage through courts is not a good solution. The civil suit procedures are so slow in most countries that it is said that to get your rights through courts you need ‘the age as of Noah (may peace be on his soul), the patience as of Ayub (may peace be on his soul), and the wealth of Qaroon. In Pakistan an experiment was made by setting up special Banking Tribunals for speedy settlements. However, the experiment did not succeed.

In my view the problem deserves further thought. Since Islamic banks cannot charge anything what they do is to treat “bad debts” as a cost item and hence charge a higher markup than they would otherwise do. That has created a bad impression about Islamic banks.

My submission to Islamic juruists is to revisit the issue from the point of view of Maslahah Aamah (public interest). Just as due to Maslahah Aamah traffic regulations have been designed and in case of violation a financial penalty is imposed, can we consider the issue that a well-functioning banking system is in broader public interest. Therefore, can the government legislate that financial penalty will be imposed on delinquent debtors. The money will be put into a "Trust Fund" designated for research and promotional activities for Islamic banking and finance.

7. Summary and Conclusions

There are circumstances when taking debt either becomes necessary or if wisely used can be a mean to creation of additional wealth. In principle, taking loans (debts) is permissible in Islam. Nejatullah Siddiqi has documented historical evidence[23] that Prophet (pbuh) himself and the rulers in early period of Islam incurred debts. Action taken during that period are considered as a valid justification to follow in later periods by a majority of Islamic jurists. Several Ahadith quoted in this paper also confirm that Prophet (pbuh) and his companions did incur debt. The very fact that in *zakah*, a portion has been kept for those who are unable to discharge their debts and in Quranic verses relating to distribution of inheritance, discharging debt *after* one's death has been mandated proves that circumstances do exist when debt has a role.

What are the circumstances under which debt can be incurred? What precautions are needed? What are the limits? What are the dangers if excessive reliance is made on debt? What responsibilities fall due once debt is incurred? What are the rights of the creditors? What legal and ethical measures are available to protect them? These are some of the questions addressed in this paper.

Our general conclusions are:

1) That in some special cases and for a limited period of time, debt can have some beneficial effects. However, the general rule is to avoid it. Individuals should try their very best to live within their means. Corporations and governments should operate within resources available to them or fairly assured to be generated from the use of borrowed money.

2) In contemporary world excessive involvement in debt seems to have far outweighed any benefits that debt creation would have. The habit forming nature of debt has caused distress in households, delaying putting their houses

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[23] Siddiqi, Nejatullah, "An Overview of Public Borrowing in Early Islamic History", Paper presented in the Third International Conference on Islamic Economics held in Kuala Lumpur, Malaysia, in January 1992. The paper has since been revised and is available on his web site.

in order in corporations and slavery type conditions for heavily indebted countries.

3) Lending based on interest coupled with conditionalities and corruption has overburdened developing countries. Heavy debt servicing has caused a return capital flow from poor to rich countries. These countries *must* be provided relief.

4) The dichotomy of real and monetary sectors is one of the basic causes of unsustainable growth on the one hand and repeated economic crises on the other.

5) Financial stability of many countries including some of the richest countries and the global financial system, have been and will remain at stake due to excessive debt, most of which is not supported by economic fundamentals.

6) Creditor-debtor relations cannot improve until the basic reasons for debt default, structural problems in economies and rationalization of legal and ethical measures are not properly addressed.

7) This paper, deriving inspiration from centuries old provisions available in the Islamic system, has attempted to make a humble contribution by deriving some principles for this purpose.

8) As a special case of the problems caused by debt delinquency, the issue of imposing financial penalty on those who owe money to Islamic banks and do not make payments on time has been studied. The author makes a suggestion that the matter be dealt by the government from the perspective of protecting public interest. Since in modern times, a well-functioning financial system is a need of the public, the government may impose financial penalty on delinquent debtors. Proceeds from these penalties should go into a specially created *waqf* (trust). The income from that *waqf* should be reserved for research and promotion of Islamic banking and finance. In this way the problem of any incentive to delay payments by the debtors will be solved. Islamic financial institutions will be 'indirectly' compensated by the activities of such a trust.