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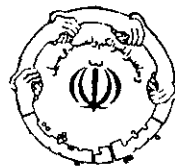
**Shaheed Ayatullah Al-Uzma
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**AN INTRODUCTION TO
PRINCIPLES OF ISLAMIC BANKING ***

* Second in Islamic Concepts Series



Translated by M. Marzban-Rad
Revised/Edited by Muhammad K. Ali



AN INTRODUCTION TO PRINCIPLES OF ISLAMIC BANKING

Second in Islamic Concepts Series.

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EDITOR'S NOTE

Several articles in the Series: «Islam, Practical Guide to Life» were written in Arabic by the late Islamic scholar, Ayatullah Al-Uzma Sayyid Muhammad Bakr Sadr, who was martyred at Najaf, Iraq. Six of the articles were obtained by a publisher in Iran. One of these was translated into Persian by Dr. Jamal Mousavi and published in 1358 AH (S.). The English version herein is based on the Persian one. Evidently, the indirect rendering into English cannot be construed as superior.

The Persian translation carries a title, which ought to be rendered into English as: «The General Foundations of Bank in an Islamic Society». However, the preliminary nature and content of the article itself has necessitated revision of the title in English as: «An Introduction to Principles of Islamic Banking». The article discusses the usury-like interest involved in capitalist banking, in the context of avoiding it in the proposed Islamic banking. For, usury is prohibited in Islam.

The macro approach of Islamic socioeconomic thought is reflected in voluminous detail in Ayatullah Bak r Sadr's well-known treatise: «*Iktasadna*» («Our Economy»), which has been translated into Persian. The same approach has been emphasised in planning an Islamic system of banking. In fact it is stated in this booklet that an Islamic Bank is not a viable proposition in a non-Islamic regime. In other words, an Islamic Bank can only thrive in an Islamic Economy. As the title of the original Arabic Series mentioned above indicates, Islam's comprehensiveness and integrity is inexorable.

Another important point in this article concerns the need to resolve the differences in approach to Islamicisation of capitalist banking, so as to retain the efficacy of the current system on the basis of Islamic requirements. No doubt, this presupposes thorough understanding of the intricacies of the existing financial institutions. At the same time, it

requires an equally thorough grasp of the relevant Islamic principles. All this means well-conceived and well-directed socioeconomic research and development.

With regard to the English translation, the editorial effort included revision of the first drafts. This has been made possible by the brevity of the article and the willing co-operation of the promising translator.

M.K. ALI
5 Zi'kadeh 1402
25 August 1982
Tehran

1. Banking in Capitalist Societies

In capitalist societies, the economic role of banks manifests itself in two ways. Primarily, it revolves around capitalism (capital formation and financing), in terms of borrowings from customers' deposit accounts for lending to individual account-holders, commercial enterprises and industrial or manufacturing concerns. In either case, capitalist purpose of dealing in capital is served, including on the basis of interest rates which are fixed at a lower level for crediting deposits and at a higher one in case of loans.

Secondly, the banks offer services, such as receiving promissory notes, paying cheques, buying and selling valuable deeds, negotiating these deeds and their safekeeping on behalf of the customers (after receiving power of attorney), among similar others. The services relevant to monetary and financial transactions, too, are based on profit motive, realized in terms of the bank's charges/commission. The financial services include floatation of company shares, opening of letters of credit and mortgages, among similar others. All these services are rendered in a practical manner, through the banks' own direct initiative and efforts.

With all the obvious importance of the banking services mentioned above, these are assigned only secondary importance, while capital-oriented transactions are given overriding importance in the capitalist world. This is reflected in their concentration on accumulating capital and multiplying the same. The role of capitalist banks largely revolves around monetary and financial exploitation of people and society, as in the West.

Thus, the second group of services mentioned above geared to the banks' primary aim of capital formation and recycling, so as to multiply wealth of the capital-owners. When the financial role assumes basic importance, as one can always discern on a close scrutiny, the capitalist banks give rise to fundamental socioeconomic

problems.

The first concerns the economic implications of capitalism itself, including augmentation and expansion of capital. The other problems are related to the basic philosophy of capitalism in so far as the use of capital at the disposal of the banks for its own purposes is concerned. No doubt, the banks subserve the overall interest of perpetuating capitalism.

Before we go into detail, we must determine what is meant by capital, and then construe it in the light of Islam. Capital is wealth, which can be used for production of new wealth. This means that the tools of production and the raw materials are part of capital. It includes cash, too. However, circulating cash cannot play capital-forming role by itself.

In capitalist economic theory, capital includes not only cash, but real assets or property. It does not relate capital to work, even as a means of producing new wealth. Capitalism regards capital as means of augmenting one's wealth, including through investment in new economic or business enterprises. For purpose of capital formation, a capitalist bank helps in floatation of companies, or buying of shares in economic or business enterprises. For purpose of capital formation, a capitalist bank helps in floatation of companies, or buying of shares in economic enterprises, and maximization of profits derived from accumulation of scattered amounts of small savings in cash and adding them up as collateral for big financing in important production sectors. Thus, money divided among people at large is collected by banks and put to use in the interest of capitalist production. This is the basic role of banks in a capitalist society.

In so far as the need for an organisation to collect savings is concerned, the banks do serve a useful purpose. This is irrespective of any economic and financial considerations behind the same. Accordingly, this activity can be recognized as important, legal and necessary. Every society, irrespective of what economic theory it follows, needs an organization to carry out the vital task of transforming nonproductive money and financial resources into productive means.

Banks in a capitalist society try to prove to the society that this activity would remain constant in all economic circumstances, and it is not in any way affected by economic dogma. The methods they use for proving the merit of their beliefs are rooted in the philosophy and economic doctrines of capitalism.

2. Purposes of Capitalist Banks

The capitalist banks need to collect deposits from their owners into the vaults. The depositors remain free of any obligation, or association, in matters concerning use of their resources. They do not involve themselves in capitalism, except for increasing their wealth. Banks make it profitable for them to deposit their monetary resources by offering interest on a percentage basis. Thus, the banks encourage potential deposits, too, through incentives for savings.

However, the capitalist banks strive to keep the percentage of interest low, so as to ensure a margin of profit for themselves by charging higher interest on loans. What counts in capitalist doctrine is not only that small amounts of money are collected into substantial capital, but it is done in the interest of capitalism only. Consequently, the overriding interest of capitalism becomes deeply rooted in a capitalist economy.

To understand how the banks carry out the capitalist purposes, it is necessary to examine the interrelationship between the banks and the overall interest of capitalism. Capital is accumulated by banks without having to work for it. As a result, capital begets more capital or wealth irrespective of any socioeconomic context. Increase and growth of wealth is meaningless until it is put to good use in an appropriate socioeconomic mould. Multiplying wealth separately from any commensurate socioeconomic benefits would amount to denying the possibility of increasing wealth through work based on an equitable distribution of income.

If the intention is to make the rich richer and nothing to affect the same, it is clear that one's wealth gets augmented simply because one is a capitalist, who does not necessarily believe in earning the increase through work. Only capitalism makes it possible. No doubt, it is important to recognise the capitalist self-centred interests as served by their banks.

The capitalist banks serve four major purposes:

- (1) Accumulating capital, **without relating the same** to any socioeconomic plan, need, or benefit, such as creation of employment opportunities.
From what source are the enterprises of capitalists financed without obtaining the capital requirements through work? The finance is derived from small deposits used for forming capital. While the capitalist entrepreneurs are provided with capital, the small depositors are compensated with minimal rates of interest.
- (2) The accumulated capital enables creation of large private enterprises. These strongly influence the economic climate, in that an economic philosophy is laid down to suit the capitalist purposes. The banks' capital obtained from small deposits based on cash, is multiplied through largescale investment in the interest of accumulating further capital. This process confers formidable power on the capitalists and their banks, so that they mutually sustain capitalism and consolidate private enterprise.
- (3) Giving predominance to the capitalist system, which is based on greed means endowing the system with the means to protect itself from any threat posed in the area of their interest-oriented loaning activities. When customers deposit money in the banks and are given interest on this money to appease them, the banks are able to immediately loan the collected money to someone else with even greater interest. Thus, while there is a regular demand for loans, there is increasing profit for capitalism, too, involving no work and perhaps no risk.
- (4) To provide necessary financial support to units of production for serving vested interests and forces of exploitation, or strengthening capitalist power to the utmost. The owners of capitalist enterprises assure for themselves constant financial backing and economic support of the banks to suit their own interests and ends.

By giving loans, profits of capitalist enterprises can be increased, so that capitalism takes root in people's economic life. Thus, banks in a capitalist society cater to the needs of capitalism, reinforcing the **same**

in a co-ordinated and interdependent manner. They thrive on everincreasing small deposits as well as big investment, involving not only capital growth, but its concentration in the hands of the capitalists. This, in turn, enables the banks to expand themselves and control the monetary and financial life of the society. In short, capitalism, with all its internal contradictions, perpetuates itself through the banks.

The important question often asked concerns the Islamic view of capitalist banks and an Islamic bank itself. A capitalist bank of the kind described earlier is not acceptable for an Islamic society. This is because of the fact that capitalist banking is not in accordance with the relevant Islamic laws. In particular, Islamic jurisprudence has established the need to prohibit loans with interest.

Furthermore, banks dealing in loans with interest would be rather incompatible with the very basis of an Islamic economy, which requires equitable distribution and judicious utilization of wealth in the interest of the wellbeing of the society as collective enterprise. In view of the nature and content of Islamic teachings, the idea of banking without interest has led to the planning of Islamic banks.

The idea of banking without interest could be astonishing to many among westernised thinkers, or those used to established thought and institutional patterns, which underrate morality and which are not susceptible to any moral approach. No wonder, a minister in a Muslim country thought that banks without interest are like circles with four sides!

3. Basic Approaches to Islamic Banking

Before discussing the basis of Islamic Banking, we must distinguish between two approaches to the idea of banking without interest:

- (1) The macro-approach of a person, who visualises banks without interest as part of a completely Islamicised society. His Islamic Plan covers all the socioeconomic aspects, and the required institutional support, such as that of the banks, conforms to the intrinsic needs of a way of life based on the Islamic ideology.
- (2) The micro-approach of a person which limits Islamic reorientation to any existing non-Islamic banks alone. It does not take into consideration the need for a complete Islamicisation of the society and its institutions. In other words, the corrupt or unethical practices of the existing socioeconomic systems are allowed to continue. What is more, coexistence with the capitalists' economic and financial institutions is also taken for granted in this approach.

These two approaches basically differ from one another. In the case of the microscopic approach, establishing an Islamic bank would mean two things. Firstly, it implies resolving of differences and practical difficulties existing between the proposed Islamic and the actual non-Islamic institutional frameworks, on the basis of Islamic *Sharia* Laws. A way should be found, so that the activity of loaning and borrowing could not be permitted when it is based on interest. At the same time, it should make the banks the source of finance for improvements in the Muslims' living conditions under a non-Islamic regime. This second need further implies competition with the financial institutions of the capitalist kind, which deal in usury, so that until Islamic Banks are fully established, capitalist banking would also be permissible.

Any establishment of Islamic Banks according to the abovementioned micro-approach, involving an arbitrary system of government, would not be really conducive to meeting the

requirements of Islamic Teachings. It would hardly enable formulation of any Islamic economy with an appropriate role for the banks, without resorting to usury. In fact, it would be rather impossible to establish an Islamic bank in a non-Islamic economy. The very idea of incorporating in secular institutions, or banks, any Islamic economic concepts would be inappropriate. Those who desire interest-free banks in a non-Islamic society would not be able to liberate the Muslims from an unlawful economic system. For, usury has been prohibited in Islam. So are the unlawful activities which arise from usury.

The macroscopic approach seeks to establish Islamic Bank in a society which is truly Islamic. This means aiming beyond liberating a Muslim society from the evils and corruption accompanying usury, or arising from it. Even so, Islamicising a capitalist bank, as part of the overall process of Islamicising the society, involves conceptual and practical problems of re-adjusting the non-Islamic practices according to Islam. Prohibition of dealing in usury will be effective only when its basic causes are removed. This means eradication of socioeconomic evils by putting into practice Islamic Laws in all walks of life. Islamic laws are interrelated. Accordingly, implementing one law should mean laying the groundwork for the success of another law, towards fulfilling the material and spiritual goals set by Islam.

An Islamic bank has a very important role to play in the economic life of Muslims. So, a distinction should be made between a bank's function of gathering capital, as in case of capitalist banking, and its commercial banking services. In this context, a bank's services can be made to conform to Islamic Laws on basis of the principles mentioned below:

- (1) Banks should provide more than commercial banking services, receiving charges at rates oriented to cost of services. In the name of charging commission, a banking service should not become a cover for any capitalistic exploitation.
- (2) The services of banks, for which they are paid, should not cause any damage to the society, whose overall interests they are expected to serve.
- (3) The banking methodology should not in any way contradict the Islamic ideology. On the contrary it should conform precisely to Islamic Laws.

For overcoming the shortcomings of capitalism, re-definition of «capital» and the relevant economic school of thought is necessary. Islamic Banks should be able to eliminate scope for exploitation of man by man, in terms of the profit motive, as in capitalist economic theory.

They should not draw inspiration from any capitalist practice. For, capitalist methods are rooted deeply in individualistic self-centredness.

Instead of resorting to capitalist methods of increasing capital with interest, Islamic Banks should have a moral orientation based on Islamic principles and standards. Subject to the Islamic criteria, Islamic Banks should evolve ways and means of achieving economic growth without the capitalist banking system.

Activities of Islamic Banks, when based on Islamic principles, will bring about the changes summarised below:

- (4) Deposits in Islamic Banks will be underwritten by an Islamic Government's central Bank, and no person or group will be discriminated against or exploited. These safeguards allow separation of any capitalistic accumulation or use of capital in the process of ensuring socioeconomic growth. The task of capital formation is best undertaken by the society as a whole, and an Islamic Government should involve itself in it on behalf of the depositors. New wealth and power resulting from this activity would not belong to any person or group. Thus, any situation where some people grab the banks' resources and power, so as to hold the financial and economic life of the people at large in their hands, is prevented.

An Islamic government is always expected to be following the *Sharia* Law, including the socioeconomic principles, criteria and standards evolved on the basis of the legal and moral requirements of Islam. So, in promoting an Islamic Economy, implementation of the relevant *Sharia* laws is crucial.

- (5) No interest, such as prohibited in Islam, should be charged by Islamic Banks. After all, interest on loans or deposits, is really an unearned wage given to users for their «trouble» of lending money. Capitalist economic theory recognises this «wage» (or profit). However, in Islam wages are lawful only when they represent payment for services involving performance of work for the benefit of others, as specifiable on a contract basis. Moreover, capital does not necessarily imply accumulated savings obtained from measurable work. Also, repaid loans do not mean any net addition to capital or to a society's resources. These and similar other reasons are attributable to the prohibition of usury in Islam.

4. Hoarding of Gold/Silver and Levy of Zakat

Islam has prohibited saving or hoarding of gold and silver, as this action prevents wealth from being spent in the way of Allah. The Holy Qur'an teaches:

«And those who hoard up gold and silver and spend it not in Allah's way, announce to them a painful chastisement.» (9:34)

Gold and silver constitute the basis of cash money, the primary function of which is to facilitate sales and purchases involved in productive exchanges. Since money is meant for spending and reimbursing expenses, its utility is reduced by not keeping it in circulation, or by reducing its volume consequent upon hoarding of gold and silver. The greater the possibility of keeping money or wealth in circulation or use, the lesser is the amount of any nonproductive saving. The greater the distribution of wealth, the greater the capacity for productive investment.

However, when the possibility of circulating money becomes limited, and the ability to regulate the same diminishes, the economic life of the people tends to stagnate. Negative impact of savings becomes manifest when resources remain unutilised over a long period. *Zakat*, an Islamic tax, is leviable on gold and silver remaining in the hands of the owner for as long as one year, which may have been a traditional practice before the advent of Islam.

The Islamic aversion to hoarding of gold and silver is a logical manifestation of the basic human need to exchange goods. Had there been no monetary transactions, barter of goods would have been necessary. When money was invented, its purpose was to make the exchange of goods easy, not to eliminate it. For example, in an exchange of wheat with cotton between the respective producer and consumer, money acts as a convenient means of payment at the time of sale and purchase both. Unlike barter, use of money is required twice

to obtain the same exchange of wheat and cotton.

Where money obtained by selling something is kept by the owner and not used for getting something else needed by him, it means stagnation of the resource. In the context of the above example, if one of the commodities, say cotton, is not bought after selling wheat, its exchange into cash is delayed, adversely affecting its potential for further productive transactions. If the necessary sales and purchases are carried out without any undue delay, by appropriately using money for the same, it would be rather impossible to accumulate cash savings with any ulterior motive of using the same for making more money in further cash-oriented commercial deals.

No wonder, Islam has prescribed *Zakat* not only on hoarded gold and silver, but on cash (coins) in hand at the end of a fiscal year (as well as its present-day counterpart: paper currency). In fact, *Zakat* laws can be applied by an Islamic authority to practically every aspect of stagnant wealth. This is indicative of the fact that the laws have their «grey» areas, which are subject to appropriate interpretation by competent Islamic administrators in the interest of the Muslims and the Islamic society at large.

A *Mujtahid* (one well-versed and well-experienced in Islamic Jurisprudence) can implement the legal provisions concerning *Zakat* in an appropriate manner. *Zakat* and similar other Islamic taxes can be collected by him directly from the people. On the other hand, an Islamic government can arrange indirect taxation, as in the case of postal and revenue stamps. In either case, a suitable procedure will have to be evolved in order to levy taxes on stagnant wealth.

Unlike secular taxation, Islamic public financing emphasises morality, benevolence and spiritual concern. The tax-paying Muslims and others are induced to overcome any selfishness or coldheartedness typical of the materialistic ethos. The Holy Qur'an assures Muslims in terms of ultimate spiritual recompense or rewards, as follows:

**«Verily those who recite the Book of
Allah and establish prayer and spend out of what we
have provided them with, secretly and openly, (can)
hope for a merchandise which will never perish.»**

(35:29)

The Qur'an recognises beneficial trading without loss. At the same time, it encourages people to help the poor and the needy in a spirit of not only charity but brotherhood, and in the way of Allah. Islam promotes a spirit of moral rectitude and goodwill even in commercial transactions, so that kindness and benevolence are always evidenced. A wholesome situation in which business-like dealings retain mutual

human concern is not too idealistic to achieve.

That Islam promotes socioeconomic wellbeing is evident from even the traditional «*Sandook Karz Al-Hasaneh*» («Public Chest for Interest-Free Loans»). These coffers were functioning even before the Islamic Revolution in Iran. People regularly deposit their contributions or valuables without expecting any interest, evidencing their benevolence in this regard. Similar other examples can always be cited from among the relevant Islamic traditions, to illustrate the practicability of Islamic socioeconomic principles. No doubt, any largescale revival of these traditions of Islam will have a salutary impact on non-Islamic societies.

5. Modality of Interest-Free Banking

To start with, an Islamic Bank announces its readiness to accept any amount of money or valuables. The basis of acceptance could be safe deposit only. Alternatively, the deposits could be treated as loans to the Islamic Bank. In either case, no payment of interest is involved. In both cases, the deposits are returnable on demand. To offset any reduction in purchasing power of money due to inflation or rise in cost of living, the value of deposits can be adjusted on basis of gold.

Accordingly, Islamic Banks not only undertake safe deposits, but underwrite real value of the same. Any upward adjustment of the value at the time of returning a deposit will not mean interest or usury.

On the other hand, a depositor can request the Bank to use the money in an economic plan with social benefit. Any resultant gain will be shared between the depositor and the Bank on a mutually agreed basis. This bilateral arrangement is called *Waaguzari*. If, however, the Bank assigns the planned utilisation to another of its customers, the trilateral arrangement is called *Modarebeh*. In the latter case, any profit is shared by the three parties on a mutually agreed basis. Also, the Bank can ask for «wages» for its efforts in arranging the deal. The amount of the wages should be commensurate with the work carried out.

In the case of *Modarebeh*, there will be no guarantee for the depositor's money, and he will have to bear any unintentional loss. This is because of his role as an investor only, who is not supposed to perform any work.

The deposits with an Islamic Bank, which are invested in bilateral or trilateral socioeconomic plans, are exempt from wealth tax. What is more, any charitable use of one's deposit would mean spiritual reward on the Day of Judgement. This does not, however, entail any payment of «wages» by a bank to depositors for the latter's charitable acts. For, both the Bank and the depositors act in good faith and with mutual goodwill and understanding reflected in their well-intended services.

6. Summary of Islamic Bank's Functions

An Islamic Bank provides physical and economic security for deposits entrusted to it for safe-keeping. Their economic security is ensured by provision of effective safeguards against inflation, based on gold. This is necessary to ensure real value of assets at the time of their return. After collecting deposits on the basis of the provisions mentioned above, an Islamic Bank will be responsible for making appropriate use of the same, in order to keep the money or wealth in circulation.

An Islamic Bank can make appropriate use of the deposits, while remaining liable to return any deposit in part or in toto, on demand. Based on the deposits, an Islamic Bank can extend interest-free loans to deserving people, including for private use, after obtaining guarantee of refund. It can extend the loans to finance productive enterprises conducive to legitimate earnings, also with a view to sharing the net profits. The financing plan can also help establish honest, capable and reliable persons in capital-intensive business activities.

Furthermore, an Islamic Bank can undertake to invest on behalf of one or more depositors, in productive activities viable from both economic and societal points of view. The latter should reflect kindness and benevolence towards the poor and oppressed people at home and abroad in a revolutionary manner. In other words, the investment should be in Allah's way, as emphasised in the Holy Qur'an:

«And whatever things you spend in Allah's way will be repaid to you, and you shall not be dealt with unjustly.»

(8:60)

Where depositors authorise investment by an Islamic Bank, the latter's role can be either that of an agent or an active participant. As an agent, it can bring about partnership between a third party and the depositor (s) in a business venture, so that any profit from the same will not be shared with the Bank, which can claim only «wages» for its

services as intermediary. If the Bank itself uses the money in a productive and profitable way, then any resultant profits can be shared between it and the owner of capital.

If Islamic Banks carry out their functions correctly and competently, capital formation and circulation are both taken care of. As a result, socioeconomically productive and beneficial activities will flourish. Accordingly, the Banks should not be motivated by their own (profitmaking) interest when inviting suitable and competent organisations to participate in joint ventures aimed at fulfilling genuine socioeconomic needs. This is necessary to avoid any undue stagnation or concentration of wealth. No doubt, Islamic Banks have a crucial role to play, in terms of leading; guiding and monitoring socioeconomic activities.

7. Concluding Remarks

An important factor in increasing production and wealth is capital. In a capitalist society, there are middlemen between producers and the consumers, who cause increases in prices of commodities to cover their own margins of profit. They act like parasites undermining the economic health of a society. Where capital becomes the responsibility of experts and workers, as in an Islamic society, the Banks would not loan money to any capitalistic parasite organisation. Thus, the middlemen and similar other profiteers will become ineffective. On the other hand, the worth of the produced goods would match their real value, based on economies of direct distribution between producers and consumers. This will have a stabilising effect on the consumer price index.

In other words, Islamic Banks should be instrumental in avoiding the interests of usury-oriented capitalism, or the selfish interests of trade and middlemen. Whenever manufacturing and trading activities call for further capital inputs, usury-based capitalists seek more unearned profit by increasing the rate of interest. Conversely, whenever there is recession, they lower the rate of interest. This is a capitalist contradiction, in that it is devoid of a wholesome approach to the socioeconomic problems. This does not really solve the problems. In an Islamic economy, the banks can devise ways and means of employing skilled people and other needy persons in small enterprises, so as to augment circulation of capital through interest-free loans and contractual participation (*Mudarebeh*).

The foregoing is indicative of how Islamic Banks can be established within an overall socioeconomic framework based on Islamic ideology. Eradicating usury and providing interest-free loans for socioeconomic benefit constitute the principal aims of an Islamic Bank. Accordingly, Islamic Banks are to be preferred by Islamic societies seeking to overcome the vested interests of capitalist banks. How best this can be achieved remains to be fully investigated and tested.

An Introduction to the Islamic Studies

Jurisprudence and its Principles
(fiqh and usul ul-fiqh)

by

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