

# Idea of Collateral and Guarantor in Islamic Bank Financing

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This study explores the idea of Islamic banks requesting for collateral or guarantee when financing, the rationale for requesting loan security, and its acceptability from Islamic perspectives. The study reviewed the previous literature and Islamic injunctions to study and justify the use of collateral and guarantor to hedge the risk of financing default. It is found that Islamic banks like conventional banking system encourage requesting loan security to ensure borrowers' commitment and protect investors' wealth. Despite its effect on loan rejection, secured loans are found to be recovered more easily than unsecured loans. Government and Islamic banks are therefore advised to device mean for helping small-scale businesses to access financing, through credit guarantee schemes and participatory financing mechanisms, to enhance financial inclusion.

**Keywords:** Collateral, Guarantor, Islamic banks, Financing, Lending

## Introduction

Over the years, scholars deliberated on the supposed responsibility of Islamic banks towards lending to small businesses. Scholars unanimously agree that Islamic banks are Shariah compliant profit-making businesses who need to take all measures to ensure safety of depositors' funds as well as to have a good return on investment. Therefore, Islamic banks cannot be compelled to take any uncalculated risk of parting with money without adequate security. There are also diverse views that, one of the fundamental objectives of Islamic financial system is to reduce complications in extending loans/financing from conventional banks. Therefore, requesting collateral before Islamic bank financing did not make it more distinct from conventional bank lending or financing. Scholars in one hand unanimously viewed the concept of extending benevolent loans without requiring any form of material benefit as one of the objectives of Islamic brotherhood, while in the other hand, they looked at the primary motive of establishing Islamic banks as holistic profit-making institutions. To achieve the two objectives, Islamic banks are expected to extent financial facilities to its customers using Shariah compliant financing instruments or mode of financing, Islamic banks can be more passionate to its customers than conventional banks, and at the same time ensure safety of depositors' and investors' funds.

Collateral and third-party guarantee are two main forms of financing security financial institutions require from borrowers during documentation process before parting with funds. This requirement is used as a buffer to fall upon in the event of borrower's failure to fulfil obligations, they also motivate borrower towards prompt repayment commitment. To feel secured from possible default, Islamic banks can hold valuable assets, titles, and other form of assurances like land titles, gold, other precious, valuable and liquid assets, Shariah compliant debentures or sukuk certificates, Shariah compliant shares certificates, takaful (Islamic insurance), third party or institutional guarantee, cash deposit, domiciliation of payment, negative pledge, Ijarah agreement, assignment of debt, letter of comfort/awareness written by a reputable person or company to a lending institution acknowledging support of its subsidiary borrowing from the bank, as well as any other means that can give comfort to Islamic bank so long as it is compliant with Shariah. Therefore, the major issues related to loan security is availability, acceptability, and compliance, as discussed in problem statement below.

## Research problem

The main purposes of financing contract are mutual benefit as well as recovery of funds. In any finance related transaction, risk mitigation and protection against moral hazard are very important decisions to ensure safety of funds (Booth & Booth, 2006). This may be the reason financial institutions requires various forms of documentations before committing their funds. However, Petersen and Rajan (1994) realized that despite benefits individuals and small businesses get from bank lending, some individuals or institutions may lack an asset or property to pledge as a collateral and may not find a worthy individual or institution to guarantee their repayment. This may be an impediment to obtaining financing to a borrower. Should Islamic banks rely on mutual trust or verbal commitment to give out financing or they should also turn-down demanding borrowers on the ground of lack of collateral or guarantor. In some cases, a borrower may have an asset, but, banks may consider that asset as insufficient or unacceptable to serve as collateral. If Islamic banks deny financing on this ground, the objective of inclusive finance may not be achieved. Islamic banks in the other hand should not indiscriminately give out money to fulfil inclusive finance objective. Meanwhile, to what extent Islamic banks are allowed by Shariah to rely on collateral or guarantee in financing contract may need to be discussed.

## Objectives of the Study

The objectives of this paper are to review previous literature and Islamic injunctions to study the reasons why Islamic banks are demanding for a reputable guarantor or collateral to secure loans against repayment default and its permissibility from Islamic perspective.

## Methodology

This paper is critical literature review based, which reviewed the previous studies on the idea of collateral and guarantee from Islamic and conventional lending practice. After a careful review of literature, the author used his theoretical knowledge and banking practice experience to draw conclusion, it is pertinent that, the author used Islamic literature to justify the permissibility of requiring guarantee or collateral to extend financing. The paper justifies the significance of this study, a literature gap identified, as well as the areas for future research need.

## Literature Review

Previous literature related to loan security (guarantor or collateral pledging) from Islamic and conventional perspectives were reviewed, the rationale for financial institutions to demand security were also reviewed to justify the current practice of Islamic banks, as discussed below:

### Loan Security

The idea of collateral or guarantee to protect a bank from undue loss on lending is derived from the fact that moral hazard is problematic in financial relationship, that is the borrower's tendency to inappropriately spend the borrowed funds with bad intent. Manove, Padilla, and Pagano (2001) and Edelberg (2004) discovered that, borrowers may likely misappropriate funds if they know there is no consequences for their action. Therefore, it is suggested that collateral or guarantee is in place to give creditor a right to repossess for recovery of investors' funds in case of any strategic default (Manove et al., 2001). Allen N Berger, Espinosa-Vega, Frame, and Miller (2011), Allen N. Berger, Frame, and Ioannidou (2016) and Frame, Srinivasan, and Woosley (2001) emphasized that banks should engage in projects' screening to reduce the chances of project failure before financing, and at the same time, be adequately covered with collateral or guarantee to mitigate risk, thereby control their recovery and social cost. Therefore, project screening is better emphasized than low cost of credit and restrictions on collateral requirement. Abildgren, Drejer, and Kuchler (2013) found that,

some lenders base their decision to lend on availability of adequate collateral, not minding borrowers' benefits on loans, while on the contrary Jiménez and Saurina (2004) found that collateralized loans have higher default probability.

Abdoui (1991) assert that Islamic banking would contribute better in the growth of small businesses than the conventional banking with its participatory mechanism of financing, which does not require tangible collateral. However, a lot of small scale borrowers are not worthy investors for participatory financing. Therefore, Islamic banks prefer to finance their projects with debt-based financing, which requires adequate loan security. Meanwhile, the Islamic banks' requirement of collateral has a tendency of discriminating poor clients in favor of the propertied rich (Pearlman, 2012).

In the study Nasir, Khalid, and Mahmood (2004), they found that Islamic financial institutions are providing financial assistance to needy people with a strong collateral or a guarantee. The borrowers surrender their precious assets or titles which are usually of higher value to obtain funds from lenders. This collateral constitutes the backbone for prompt repayment of these funds to financial institutions. Sharif, Shaharuddin, Muhamed, Pauzi, and Zin (2013), explored the potentials of using collateral (Ar-Rahn) acceptance by Islamic financial institutions to extend financing facilities to entrepreneurs through pawnshop. This may enhance access to finance, comfortable, less cost, and easy lending. They concluded that if implemented it will become a complimentary product in the financial markets.

Maulidia (2003) contributed that, since pawnshop serves various purposes such as safe custody and loans security. Therefore, it is appropriate for pawnshops or financial institutions to charge processing fees, appraisal fees, and safe custody charges. This may be a source of income to the lender instead of relying on interest bearing financial services. Rajan and Winton (1995) argue that collateral may serve as an instrument to increase the lender's monitoring incentive and comfort zone, because collateral is only likely effective if its value is constantly and consistently monitored. Therefore, holding collateral may increase cost of monitoring financial obligations.

(al-Anshari, n.d.) added that financial institutions may require collateral to secure their funds, because lending to customers is among the riskiest part of their business. They lend investors' funds to borrowers, as they are lending, they experience different forms of problems from borrowers which result to strategic default. Therefore, they rely on holding collateral assets to be assured that investor' funds are safe. Hamid, Rahman, & Halim, (2014) attempted to examine the theoretical and practical factors of accepting Islamic-based pawn broking (Ar-Rahn) scheme in Malaysian using seven factors such as Shariah view, pricing system, pledge assets, customer service, locality, social and advertisement factors. They realized that, Shariah view have the highest mean score followed by pricing then pledged asset. This indicate that, the key criteria that all customer emphasis when they choose the services of Ar-Rahn scheme is Shariah compliance and pricing. Lawal (2016) quoted Badagawa (2006) that, financial institutions require borrowers to present to them assets which would be in form of physical property, land and building titles, vehicle logbooks and other assets. In case of failure to repay by the borrowers, these assets will be seized by the lending institutions and sold off to get back part whole of the borrowed funds.

Booth and Booth (2006) established a cost-benefit relationship of borrowing cost and collateral issue; they found that, collateral pledging decisions are consistent with minimized cost of borrowing. Borrower pledging collateral means a bank is hedging the loan against risk, hence the lower expected return goes with the lower risk taken. It is also found that, Islamic banking participatory products according to some researchers like Al-Ajmi, Abo Hussain, and Al-Saleh (2009) are likely to have higher transaction cost than interest bearing loans, the absence of collateral tendering has normalized effect of the cost difference.

Various studies like that of Akpan, Patrick, Udoka, Offiong, and Okon (2013) and Manove et al. (2001) found that non-availability of collateral is a major problem to borrowers. However, for a lending bank to feel safe, they may request for a guarantor in place of collateral. A guarantor is a third party (person, group of persons or institution) that can agree and sign to undertake to be held liable for payment of debt obligation in the event the borrower defaulted. In conventional setting, most of the time it's a job of the private guarantee firms or insurance cover that serve as a guarantor to borrower's project. Therefore, riskier borrowers prefer to pledge collateral than guarantee to avoid additional cost (Chen, 2006). Although, loan guarantee schemes have incremental effect on the cost of loans, but it remains important in increasing access to financing. The incremental effect can as well be reduced if government can serve as a guarantor to small scale businesses (A. Riding, Madill, & Haines, 2007). In another study, A. L. Riding and Haines (2001) reiterated the importance of government serving as a guarantor to small businesses as its contribution to economic growth and employment generation. Chang, Chung, and Yu (2006) found group lending guarantee as more effective in reducing probability of loan default.

Guttman (2007) realized in a moral hazard model of group lending to micro credit borrowers that group size is insignificant to repayment performance, but social collateral has significant influence on repayment performance. This influence is possible only when the group members are willing to apply social sanctions on delinquent borrowers. Sometimes, the design of collective credit agreements where all members are jointly responsible can potentially induce peer monitoring, enhance the lender's ability to elicit debt repayments and reduce the incidence of strategic default (De Aghion, 1999). Financial institutions' reliance on joint liability lending to the poor are common in developing countries. This is largely due to its informational and enforcement advantages over other forms of lending. Collective lending promotes screening, monitoring, verification, and enforcement of repayment (Ghatak & Guinnane, 1999). However, the success of joint liability lending depends on the borrowers' willingness to cooperate with one another on a common goal, Paxton (1996) and the success of group lending repayment rates vary dramatically from one program to another, suggesting an inherent instability in the financial technology. Simtowe, Zeller, and Phiri (2006) found that lenders feel comfortable and relaxed with group lending to mitigate moral hazard. Lending institutions relying on social cohesion and dynamic incentives enhance borrowers' creditworthiness and it has direct implications on borrowers' future outreach, impact, credit rating and sustainability.

### **Why Islamic banks need to secure their loans?**

Extending loan to a needy by Islamic bank can be considered as an act of *Ibadah* (good deed), as long as it is within the Shariah mandate and the funds can be utilized judiciously. This is justified by the hadith of the Prophet (SAW) in Sunan Ibn Majah, The Chapters on Charity Book 15, Hadith 2525 as follows:

*"It was narrated from Anas bin Malik that the Messenger of Allah (SAW) said: "On the night on which I was taken on the Night Journey (Isra), I saw written at the gate of Paradise: 'Charity brings a ten-fold reward and a loan brings an eighteen-fold reward.' I said: 'O Jibril! Why is a loan better than charity?' He said: 'Because the beggar asks when he has something, but the one who asks for loan does so only because he is in need.' "(Da'if) (Siddiqui, 1972e).*

In the work of Bensaid, Grine, Nor, and Yusoff (2013), most loans are genuinely for business purposes or necessary to augment consumption. Therefore, it is good to offer loans, because the person who ask is in need, the lender can be rewarded for it. Meanwhile, banks cannot rely on willingness to give out loans without consideration for possible risk of not being paid back. It is therefore recommended to lenders that they should at the same time take extra care in protecting funds against undue default of repayment.

Ibn Kathir is one of the scholars that explained very well about collateral (Arrahn) in surah al Baqarah verse 283 (Al-Qurashi, 1999). Bukhari and Muslim also recorded many hadiths about collateral and guarantee.

Other great Islamic scholars such as Ibn-Abidin, al-Ḥaṣkafī and al-Shaybani of Ḥanafī, described the need for collateralization of asset in lending, how it is applied, and its principles. They also discussed the need for financial institutions use collateral or guarantee to secure loans.

Business involving debt obligation requires familiarity between lender and borrower. Nowadays, relationships are easily built using modern information processing system, which eases lender-borrower relationship, but, cannot guarantee repayment of debt obligation (Kong, Turvey, Xu, & Liu, 2014). According to the literature of Chakravarty and Yilmazer (2005), lenders cannot just rely on credit scoring information alone to give out financing, they need to be extra careful to monitor the effect of possible moral hazard of borrowers. Frame et al. (2001) while writing on the effect of credit scoring, assert that lenders are now ready to take risk of lending to consumers, particularly through credit card, which has relatively lower default rate, but, they constantly monitor customers. Bharath, Dahiya, Saunders, and Srinivasan (2009) realized the advantage of repeated lending to the same borrower, which overtime reduce borrower transparency investigation cost and a chance of borrowing at a lower cost, but, lenders require periodic review of borrowers' credit score. In the work of Akpan et al. (2013), where they examined the determinants of credit access and demand in Nigeria, years of borrowing experience and relationship, level of education and availability of collateral or surety determines amount a bank can lend to its client. Clients' continuous loyalty may likely influence bank's ability to extend credit to borrowers without collateral.

### Permissibility of Collateral in Shariah

Islamic banks may require collateral to protect themselves against possible default by borrower. The idea of collateral is derived from the concept of Ar-Rahn (pawning). Ar-Rahn means pledging of an asset or tittle as a security to obtain loan or financing from a pawnshop. The concept of Ar-Rahn has a legal justification from the holy Qur'an in surah al-Baqarah verse 283:

*"And if you are on a journey and cannot find scribe, then a security deposit (should be) taken".  
(Al-Qurashi, 1999).*

Another Hadith of the Holy prophet (SAW) from Sahih al-Bukhari sales and trade Book 34, Hadith 49 also gave a justification for using collateral as follows:

*Narrated 'Aisha: "Allah's Messenger (PBUH) bought food grains from a Jew on credit and mortgaged his armor to him" (as collateral). (Siddiqui, 1972b)*

Banks alternatively require borrower to present a guarantor, who may be held liable in case of strategic default. In the Islamic perspective, guarantor is a person interceding for borrower to access financing and is liable if borrower defaulted based on the following Hadith in Sunan Ibn Majah, the chapters on charity Book 15, Hadith 2497:

*Narrated Shurahbil bin Muslim Al-Khawlani said: I heard Abu Umamah Al-Bahil say: "I heard the Messenger of Allah (SAW) say: "The guarantor is responsible, and the debt must be repaid"  
(Hasan) (Siddiqui, 1972d)*

Interceding (guarantee) may be a risky responsibility, but, it is encouraged in Islam to mutually help one another. If a person need intercession (guarantee) in his business obligation or in borrowing, it is good to assist him, as recommended by the Prophet SAW in Sahih al-Bukhari, book of Tawheed book 97, Hadith 102

*Narrated 'Abu Musa: Whenever a beggar or a person in need of something came to the Prophet (PBUH), he used to say (to his companions), "Intercede (for him) and you will be*

*rewarded for that, and Allah will fulfill what He will through His Apostle's tongue." (Siddiqui, 1972a).*

Sometimes group guarantee may be required to large number of borrowers from a single source. The Prophet SAW encouraged this act as an Ibadah in Jami' at-Tirmidhi, chapters on the description of the day of judgment, Ar-Riqaq, and Al Wara' Book 37, Hadith 2627.

*Abu Sa'eed narrated the Messenger of Allah (SAW) said: "Indeed in my Ummah there are those who intercede for large groups of people, and among them (there are) who intercede for a tribe, and among them (there are) who intercede for a group and among them (there are) who intercede for a man, until they are admitted to Paradise." (Da'if) (Siddiqui, 1972d)*

In another hadith of Sunan Abu Dawood, Wages (Kitab Al-Ijarah) Book 24, Hadith 126, it is not allowed to get paid for intercession (guarantee), it is regarded as an act of Ibadah (help) as the Prophet SAW said:

*Narrated Abu-Umamah: The Prophet (SAW) said: If anyone intercedes for his brother and he present a gift to him for it and he accepts it, he approaches a great door of the doors of usury. (Siddiqui, 1972c).*

Therefore, the concept of guarantor differs in Islamic and conventional perspective, in such a way that no fee is paid for intercession in Islam and the beneficiary of the guarantee is expected to fear Allah (SWT) in discharging his contractual obligation appropriately. Guarantor is expected to intercede as an Ibadah (worship), despite the liability attached to be a guarantor.

## Current Practices of Islamic Banks

Islamic banks like their conventional counterparts requires collateral or guarantee to cover loans against possible default. They are not requesting for loan security because they are wishing to create complications, but, to avoid the effect of moral hazard from dubious customers who wish to illegally extort banks' money. They also rely on the permissibility of collateral and guarantee from Islamic perspective to create a comfort zone for themselves. Islamic banks use the concept of loan security to ensure that only committed and serious-minded borrowers are being financed.

Islamic banks are careful enough to avoid rejecting genuine loan request on the ground of lack of collateral or guarantor, by devising other means of financing like hire-purchase. Even though, the asset financed serves as a collateral for financing yet Islamic banks are also careful to avoid financing wrong business projects just because the entrepreneur has a collateral or guarantee. Islamic banks engage on other means of project screening to ensure genuineness of the project to be financed.

Islamic banks sometimes reject financing request of customers who do not fulfil certain conditions or requirements. Even though, a customer's loan request may possibility be rejected for genuine reasons, rejection for lack of collateral or guarantor may not be welcomed by a customer who needs immediate financing, sometimes rejection may turn to be a blessing in disguise Krasniqi (2010), particularly when the consumption is not necessary or time bound. Bai and Lu (2018) found only risk averse and higher income earning borrowers are likely to reject loans previously applied, if the terms of the loan are not favorable to them. Such borrowers have advantage of privileged information, bargaining power, knowledge, and alternative source of financing. Usually, lenders hardly reject their funding request because they seem to be qualified by all ramifications. But, small and unexperienced borrowers' request for loan were usually denied on the ground of inadequate loan security.

Impact of business financing can be assessed based on the cost benefit analysis of the borrowing, Adams and Nehman (1979) defined cost of borrowing as official rate payable, borrowers' loan transaction costs and changes in the purchasing power of money. If cost associated with borrowing exceeds benefit, then the loan process has negative impact on clients. This cost comprises not only interest or profits chargeable by lending bank, but including all processing charges/fees, associated tax if any, commission on transactions as well as additional expenses a borrower may incur on the process of accessing financing. Consumer borrowers incur substantially high-priced cost of borrowing from formal loans market compared to large scale borrowers, Adams and Nehman (1979) argue that high borrowing costs is deterrent to small-scale financing, particularly those living with low income or in developing countries. It is realized that, cost associated to documenting collateral tremendously increases cost of financing.

Hubbard, Kuttner, and Palia (2002) established that small consumers spend higher as a borrowing cost from low capitalized and bigger lending corporations. In the study of (Petersen & Rajan, 1994) long standing banking business or lending relationship can only increase availability of credits but do not have effect on cost of borrowing. While, high cost of loans supposed to deter borrowers, sometimes cost of borrowing does not affect borrower behavior, but, individuals' rationality does (Morduch, 2010); some borrowers just have a preference to borrow even if they have savings. This is evidenced by borrowers in India, who are more willing to take loans than to temper with their savings, and others who borrow while they have an asset that can be easily converted to cash, claiming that borrowed funds can be repaid faster than tempered savings. Dasgupta (1972) suggest the use of financial and non-financial cost-benefit analysis to measure the worthiness of borrowing using indices like utility, social cost-benefits, input constraints, time value and time phasing, risk and uncertainty, disaster and loss control, availability of alternative, objective and subjective probabilities as well as your future and for public good which can be used to measure the worthiness of borrowing.

## Discussions and Recommendations

Despite permissibility and importance of requiring loan security by banks, it is an impediment to the current financial inclusion strategy objectives, because it deters small scale borrowers from applying for bank financing. Although, banks have genuine reason to reject loan applications for fear of default, but it is not supposed to deter small borrowers from access to financing. Therefore, banks should device a means to help small business borrowers at the same time protecting investors' funds.

Government intervention schemes are supposed to compliment the objectives of financial inclusion strategy through easy access to bank financing. Government through central banks should establish loan guarantee schemes for small business borrowers, through associations and clubs.

Religious obligations of extending benevolent loans to low income earners is not enough reason to extend loans so long as there is possibility of defaulting. Therefore, the society should intensify effort to mitigate risk of loans default and moral hazard issues.

It is realized that, banks are more comfortable to extend loans to group of small scale borrowers if they form an association with group guarantee. In group guarantee, all group members stand to be guarantors for one another, where default by one member means default by all the group members. Therefore, small scale borrowers are advised to form a group in the form of cooperative society to obtain loans with group guarantee.

It is therefore, recommended that future research should look at a better way for Islamic banks to extend financing (both participatory and non-participatory) to small businesses without the need of collateral or guarantee, at a lowest possible default rate. Future research should also review current practice to see if Islamic banks are compassionate to small scale businesses towards lending relationship and suggest way forward to increase lending to small businesses.

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