



ISLAMICITY OF BANKING AND MODES OF ISLAMIC BANKING

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ABSTRACT

Economists, bankers, jurists, and other Islamic scholars interested in the discipline of banking have mainly focused on the issue of whether interest is *riba*, and if yes then how to conduct interest-free banking? To this end, several alternatives to interest have discovered and very successfully put into practice by the contemporary Islamic banks. The alternatives include some trading models like *murabaha*, *bai mu'ajjal*, *bai salam*, *bai eenah* and others. The current study identifies a major problem in using these trading modes for the purpose of financing. This analysis also uncovers some other discrepancies between application of these modes and related injunctions from the *Qur'an* and *Sunnah*. The concentration on the issue of *riba* in banking has kept a larger issue out of sight. The issue is whether a banking system itself, comprising central banks and commercial banks, irrespective of the use of interest, is consistent with the injunctions of Islam. The concepts of the Money Expansion Multiplier and Quantity Theory of Money reveal that the central banks and commercial banks, irrespective of the use of interest, is consistent with the injunctions of Islam. The concepts of the Money Expansion Multiplier and Quantity Theory of Money reveal that the central banks and commercial banks usurp people's property in the form of *seignorage* by expanding money supply. Such outcome is also condemned by express verses in the *Qur'an*. It is therefore concluded that the entire banking system and the operations of contemporary Islamic banks are of doubtful validity. Hence some measures are suggested for restructuring of banking to advance the cause of Islamization.

ISLAMICITY OF BANKING AND MODES OF ISLAMIC BANKING

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Financing on the basis of interest has been declared an illegitimate mode of finance from an Islamic point of view. Therefore several interest-free banking institutions, called Islamic banks, have sprung in many countries since early 1960s that cater for the banking needs of the Muslim population. Although these banks have successfully replaced the practice of interest with other modes like *mudarabah*, *musharakah*, *bai murabahah*, *bai bithaman ajil*, *bai eenah*, and *ijarah*, doubts regarding their Islamicity still persist. The current study explains the reasons behind those doubts. In addition, the study also examines the Islamicity of the functions of central banks and the commercial banking system. It is found that functions of both the central banks and the commercial banking system are contrary to teachings of the *Qur'an*. Therefore some measures are forwarded that, if adopted, would enhance Islamicity of the entire banking system.

The analysis here proceeds as follows. Some intellectual and business developments are reported in section 2 that indicate an astounding success in the area of Islamic banking. In section 3, Islamicity of the modes of financing applied by the Islamic banks

is examined in the light of a definition of *riba* derived from the *Qur'an* and *Sunnah*. Validity of the central banking and commercial banking system is discussed in sections 4 and 5 respectively while measures to enhance Islamization of banking are presented in the last section.

Intellectual and Business Progress Towards Islamic Banking: An Overview

Declaring interest as *riba* and consequent detection of interest-free modes from the *fiqh* literature to replace banking operations paved the way for emergence of Islamic banks that have, in general, shown a remarkable success. The intellectual and business success covering a debate on the question whether interest is *riba*, discovery of interest-free modes for banking and a business profile of Islamic banks are briefly reported here.

A Debate on *Riba*

All people who deal with banks in the capacity of depositors as well as borrowers are well aware of the practice of interest in banking operations. Resemblance of interest with *riba* naturally made devout Muslims restless because of the prohibition of *riba* by the *Qur'an* in the following words "give up whatever is left in lieu of *riba* if you are indeed believers. If you do not do so then take a notice of war against you from Allah and His prophet" (*Al-Baqarah*, 2:278-279). This shows importance of the debate that raged among the supporters and opponents of banking interest on the question whether interest is *riba*. Numerous studies have discussed the matter and the scholars have advanced opposing opinions on this issue. A group of scholars opine interest is not *riba*. For example, Hashmi claims that interest is nothing but

mudarabah (PLD, 2000, 654) while Tantawi, the Grand Shaikh of Al-Azhar, declared that the interest-based banking is akin to *mudarabah* and *murabahah*.¹ However, majority of the contemporary writers holds the view that interest is *riba*. Comprehensive discussions on the views expressed and justifications provided by various camps are available in the Pakistan's Federal Shariat Court Judgement on Interest (PLD, 1992) and the Supreme Court Judgements on *Riba* (PLD, 2000).²

Discovery of Interest-Free Modes for Financing

Declaring interest as *riba* intensified the search for discovery of interest-free modes to conduct banking business. This pursuit has resulted in the discovery of twenty-one (21) operational modes to perform all types of banking transactions on interest-free basis. These modes comprise *mudarabah*, *musharakah*, *musharakah mutnaqisah*, *ijarah*, *ijarah wa iktina*, *murabahah*, *bai salam*, *bai mu'ajjal* (*bai bithaman ajil*), *bai istisna*, *bai eenah*, *muzara'a*, *musaqah*, *qardhul-hasan*, *wakala*, service charge, sale on installments, development charges, equity participation, sale and purchase of shares, purchase of trade bills and financing through *auqaf*. Institutions providing financing on the basis of these modes are called Islamic banks. This change of name from banking to Islamic banking represents a worthwhile psychological achievement as participants in the banking industry now make use of Islamic terminology in their business discussions. This is an important step towards Islamization of banking even though, as shown below, it is merely a change in form rather than substance of banking business.

Replacement of interest was conceived due to strong verdict against *riba* and equivalency of interest with *riba*. Therefore the supporters of Islamic banking addressed practical difficulties and sought solutions to those difficulties that could arise if interest

was rejected. The approach has been to retain banking structure with all its ramifications except interest. In this pursuit, operational technicalities have taken precedence over other concerns. The situation is deplorable because adoption of the pragmatic approach has led to a sort of Islamic banking that, as found below, also falls within the ambit of *riba*. However, whatever has been accomplished so far is laudable because its successful progress over its conventional counterpart certainly indicates presence of a yearning for an Islamic banking system that would be different from the prevailing interest-based system.

A Business Profile of Islamic Banks

Proportions of financing under each mode can indicate importance of each technique to the Islamic banks. The minimum and maximum proportions in bank financing under each mode, averaged for ten (10) leading Islamic banks, are as follows: *murabahah-cum-bai mu'ajjal* 45%-93%, *musharakah* 1%-20%, *mudarabah* 1%-17%, *ijarah* (leasing) 0%-14% and other modes 0%-30% (PLD, 2000, 308). Husain (n.d, 10) reported Bank Islam Malaysia Berhad's financing by mode for the year ended on 30 June 1999 as: *murabahah-cum-bai bithaman ajil* 91.55%, *ijarah* 3.41%, *musharakah* 0.52%, *mudarabah* 0.47%, and *qardul-hasan* 2.63%. It is obvious from these figures that *murabahah* (including *bai bithaman ajil*) is the most popular mode with the Islamic banks. Of course, one wonders why only *murabaha* has gained such prominence out of the 21 modes listed above. This question will be addressed later in this study. A related question is how the Islamic banks have fared?

According to a report by the International Union of Islamic Banks, there are 176 Islamic banking institutions in the world out of which 47% are in the South and South East Asia, 27% in GCC and the Middle East, 20% in Africa and 6% in the Western countries.

Deposits and total assets of the Islamic banks are US\$112.6 billion and US\$147.7 billion respectively. Islamic banking is growing at a rate of 10-15% per annum compared with the growth rate of 7% recorded by the global financial services industry (PLD, 2000, 739-740). According to another account provided by M. Iqbal Khan, head of the Islamic banking division of HSBC London, there are over 200 Islamic banks operating in 65 countries with a population of around 1.3 billion. Islamic banks' capital is US\$90 billion that is growing at the rate of 15% per annum. (PLD, 2000, 385-387 & 739).

The latest available comparison of performance of Islamic banks with conventional banks is the one by Munawar Iqbal. He compared performance of both types of banks of equivalent size during 1990-1998 in terms of equity, deposits, investments, assets, capital-asset ratio, liquidity ratio, deployment ratios, cost-income ratio, return on assets (ROA) and return on equities (ROE). He concludes "Islamic banks as a group out-performed the former in almost all areas and in almost all years." For example, ROA and ROE for Islamic banks were 2.3% and 22.6% compared with 1.35% and 15% for the conventional banks (Iqbal, 2000, 424-30). By all counts one can conclude that the Islamic banks have fared much better than the interest-based banks. It would be interesting to know the reasons behind this success that are partly addressed in the rest of the paper.

One may notice, however, that the techniques applied to measure the performance of Islamic banks are the same as used by the interest-based banks. This shows the Islamic banks are competitors of interest-based banks. In other words, both types of banks are in the same business: taking deposits and extending credit. Proper application of the Islamic modes would have set Islamic banks apart from the conventional banks. It did not happen in reality because the Islamic banks, which were supposed to turn

into traders and entrepreneurs, manipulated the financing modes in ways that retained their identity as lenders rather than entrepreneurs. Therefore such measures are needed that would ensure that Islamic banks are transformed from the traditional lenders to the Islamic entrepreneurs. Otherwise, question regarding Islamicity of their operations, discussed below, would continue to confuse the Muslim mind.

Islamicity of the Modes Used by the Islamic Banks

It would have been ideal to find validity of the modes applied by the Islamic banks by direct references from the *Qur'an* and *Sunnah*. The records in the revealed sources on the use of financing techniques favorite to the Islamic banks are insufficient. Therefore consequences of Islamic banking operations, rather than the techniques themselves, are assessed in the light of the injunctions of *Qur'an* and *Sunnah* to determine their Islamicity. Towards this end, first it would be established that time value of money is synonymous with *riba* in case of all deferred exchange transactions. Thereafter, Islamicity of the financing modes and some ancillary concepts applied by the Islamic banks would be evaluated, partly in terms of the concept of the time value of money.

Time Value of Money and *Riba*

Riba is generally classified into two types: *riba al-fadhl* and *riba al-nasia*. A common component in both types of *riba* involves exchange of two similar commodities³ in different amounts. The difference so accrued to a party is called *riba*.⁴ A reading of the *ahadith* and the *Qur'anic* verses related to *riba* shows any gain resulting from exchange of two similar commodities in different amounts is *riba*. This definition holds true for both spot as well as deferred

exchange contracts.

Riba in spot exchanges of two similar commodities is evident in many *ahadith*. For example, the prophet (s.a.w) said "gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, hand to hand. If these types differ, then sell them as you wish, if it is hand to hand" (Muslim). So any gain resulting from spot (hand to hand) exchange of similar commodities, like dates of different qualities, in different amounts was pronounced *riba* and disallowed by the prophet.

Riba in deferred exchanges of two similar commodities is dealt within the *Qur'an*. *Qur'an* says, "if you repent (from *riba*) then your capital sums are for you, deal not unjustly, and you shall not be dealt with unjustly" (*al-Baqarah*, 2:279). Deferred exchanges normally result in credits and loans. The verse indicates that there would be no *riba* if the creditors retrieve only the principal amount from their debtors. That means, whatever commodity is the subject of deferred exchange that commodity shall be returned in the original amount irrespective of the period of indebtedness and any amount charged above the principal would be *riba*. Money⁵ is treated as a commodity in exchange transactions because gold and silver were money during the advent of Islam. Therefore if the debt is in the form of money then the lenders are entitled to receive only the amount lent. Otherwise *riba* will take place. It is obvious therefore that *riba* in deferred transactions is nothing but a charge for the period of indebtedness. In the economics literature this charge is also called a time value of money that represents a rental for the use of money for a certain period. That is why interest representing time value of money stands prohibited. This position is confirmed from the verse "if the debtor is in a difficulty then grant him time till it is easy for him to pay" (*al-Baqarah*, 2:280). Therefore one must conclude that, according to the *Qur'an*, time value of money is *riba*.⁶ An analysis of the contemporary Islamic banking practices

shows that time value of money is a part and parcel of all financing transactions.

An Analysis of Islamic Banking Practices

As noted above, the Islamic banks have mainly relied on trading modes, like *murabahah* and *bai bithaman ajil*, to finance their customers' needs. Heavy reliance on trading modes makes sense for two reasons: firstly, it indicates compliance of the injunctions "Allah has permitted trading and forbidden *riba*" (*al-Baqarah*, 2: 275) and "O believers, do not devour your properties among yourself by wrong means except selling with mutual willingness"⁷ (*Nisaa*, 4:29). Secondly, it is convenient to charge time value of money in the name of a profit margin on their financing in place of the interest charged by the conventional banks. Similarly, *mudarabah* financing that was in vogue during early Islam and was practiced by the prophet (s.a.w) himself has been extended into a two-tier *mudarabah* because then it would be possible for banks to charge profits in the sense of time value of money. However, it did not gain popularity because the risks are relatively much higher in *mudarabah* than *murabaha*. Similar misuses are detected in the use of other Islamic principles applied by the Islamic banks. Therefore Islamic banking practices remain of doubtful validity. Anyway a detailed analysis of salient principles applied by the Islamic banks follows.

The basic function of a bank is to accumulate deposits at a cheaper rate to deploy the same at a higher rate and thus earn a spread. Exchanging two similar commodities or two heterogeneous commodities can provide income. If a gainful exchange of two similar commodities is *riba* then a gainful exchange of two heterogeneous commodities must be selling because "Allah has permitted selling and prohibited *riba*" (*al-Baqarah*, 2:275).⁸

Therefore, earning of legitimate profits must involve exchange of two heterogeneous commodities.⁹ Otherwise the earnings would be *riba*.

Both types of banks, Islamic and interest-based, issue credit to seek returns. Islamic banks do not engage in trading activities because they are not interested to become entrepreneurs. Instead they prefer to loan money to the entrepreneurs, like the interest-based banks. Therefore they must find ways and means to charge time value of money, like interest. (One way is to pose as traders by engaging in a fictitious purchase, adding profit component to the purchase price to arrive at a selling price of the purchased item and then sell the item to the customer at deferred price. So treat the selling price as a credit (loan) due. The difference between the sale price and the purchase price is time value of money that is equivalent to interest. This is the essence of all financing transactions based on trading modes including *bai ad-dayn*, *murabaha*, *bai bithaman ajil*, *ijarah* and *bai eenah*.) The difference is that the interest-based banks treat the amount advanced (equivalent to the purchase price) as principal loan while Islamic banks treat the amount due at maturity (selling price) as principal loan. However, any observer shall have no qualm about agreeing that the principal has to be the amount that a bank advances in favor of the customer and not the amount the bank expects to retrieve. In this way it is clear that the profit added to the principal is nothing but *riba*. It is also true because Islamic banks use the same formulas and annuity tables for computing amount due and monthly installments for (say) *bai bithaman ajil* and *ijarah* transactions¹⁰ which are used by the interest-based banks.

In sum, the loan from an Islamic bank represents the amount advanced plus time value of money. Normally the customer is asked to purchase the desired item but in the name of the bank. If the selling price (debt) is payable in lump sum then the transaction

(in Malaysia) is called a *murabaha* (instead of *bai mu'ajjal*). If the debt is payable in installments then the transaction is called a *bai bithaman ajil*. Sometimes a customer is interested in buying use of a commodity and not the commodity per se. So the utility of a commodity may be sold to a customer by an Islamic bank under an *ijarah* (lease) contract. There are two types of lease: operating lease and financial lease. Banks practice only financial leasing because it is convenient to embed time value of money, as in case of *bai bithaman ajil*, so the amount due on the financial lease becomes a debt due.¹¹

All these financing transactions fall under the category of *bai ad-dayn* because *bai ad-dayn* refers to a transaction whereby a commodity (or service) is bought at a deferred price. *Dayn* is permitted in the Qur'an.¹² In Malaysia, *bai ad-dayn* refers to a situation of buying and selling a debt, without engaging a commodity (BIMB, 1994, 104-105). Scholars outside Malaysia do not accept this interpretation because an authentic hadith prohibits sale of *kali bil-kali*, that is, debt against debt. (PLD, 2000, 566)

Sometimes the bank may buy an item from the customer himself (instead of requiring him to buy something on behalf of the bank) at a lower spot price and sell the same back to the same customer at a higher deferred price. This is a *bai eenah* transaction. The bank, in order to conduct a *bai eenah* transaction may reverse the buying and selling role. That is, a bank may sell something to the customer at a higher deferred price and buy it back from the same customer at a lower spot price. *Bai eenah* is prohibited on the basis of an authentic *hadith* that refers to a conversation between a lady, Umm Muhibbah, and Aisha (r.a.a). The lady sold an item to Zaid bin Arqam (r.a.a) at a deferred price of 800 dirhams. Later on he decided to sell that item and the lady bought the same item for 600 dirhams. On hearing this, Aisha (r.a.a) became furious and said it was a wrong deal. She shall inform Zaid bin Arqam (r.a.a) that he

has wasted his *haji* and *jihad* by doing so. (Kakakhel, 1984, 10).¹³

Notice that these are apparently two heterogeneous exchanges yet they are prohibited because these two exchanges boil down to a single gainful exchange of money with money. Commodity may be brought into the picture to put a trading label on a lending transaction that yields *riba*. If *bai eenah* is prohibited for this reason then other transactions like *murabahah* involving debt are also subject to prohibition.

It is instructive to judge these transactions in the light of the following hadith. Imam Awzai reported that prophet (p.b.u.h) has said: "A time shall come to mankind when they will legalise *riba* under the garb of trade" (PLD, 2000, 518). The main problem in each of these transactions is that time value of money (*riba*) creeps into the banking transactions whenever a trading device is applied to render a financing facility. One of the difficulties faced in Islamization of the banking system, argues Ebrahim Sidat, is that people consider *murabahah* as a financing instrument instead of treating it as a trading device (PLD, 2000, 373).

Allah has made it obligatory to document *ad-dayn* transactions (see *al-Baqarah*, 2: 282-283 in footnote 12 above). The documentation shall be witnessed by at least two persons. The debtor shall dictate contents of the document. Allah deems the documentation to be just, suitable for evidence and convenient to prevent doubts. Collateral, to serve these aims, is permitted provided preparation of documentation is not feasible. Therefore collateral (*rehn*) is meant to serve as a proof of the deferred transaction in lieu of documentation, not as a surety to recover the debts. Islamic banks require collateral¹⁴ as surety. Lawyers and solicitors prepare sophisticated documentation at the behest of the bank, not the debtor. Yet documentation cost is charged from the debtor because "preparation of the document of loan has been held to be the responsibility of the borrower which naturally means

that if the documentation involves some expenses, they will be borne by the borrower." (PLD, 2000, 315). These transactions are also justified on the pretense of a willing buyer willing seller situation to comply with the injunction on "trading with mutual consent" (*Nissa*, 4:29).

Trading with mutual consent, a condition that is dictated in the *Qur'an*, shall not be violated. However, fulfillment of this condition is not sufficient to legitimize every transaction. It is well known that transactions involving *riba*, gambling and illegitimate sex are prohibited even if the condition of willing seller willing buyer is met. In case of *murabahah*, for example, the fact that a customer agrees to buy an item (say a house) from an Islamic bank at an exploded price of \$227,644.80¹⁵ that he himself bought at a much lower price of \$100,000 on behalf of the bank from the market is itself a proof that the transaction is made under duress because the customer lacks funds to buy the item. This arrangement provides him a debt against time value of money of \$127,644.80. Therefore mutual willingness of an Islamic bank and its customer for conduct of transactions containing charge over and above the principal (market price) due to consideration of time is not a sufficient reason for validity of the transactions. Moreover, in Malaysia, the customers are entitled to a discount, calculated on the basis of the same formulae applied to calculate bank profit, for the period of early payment if the debt is cleared before maturity. This confirms that there is no difference in the profit charged by the Islamic banks and the interest charged by the conventional banks. Hence, by all counts, Islamic banks are operating on the basis of time value of money that, of course, is *riba*.

Banks may acquire deposits on the basis of *mudarabah* and advance the same to a third party to conduct business on the basis of another *mudarabah*. This is called two-tier *mudarabah* in the literature. This way the banks can benefit by exchanging money

with money in different amounts. Otherwise the banks will have to directly channel deposits into trading activities themselves to make profits. *mudarabah* financing was a commonplace during the life of the prophet (pbuh). However, no instance can be traced whereby one party obtained funds on *mudarabah* from another party and forwarded the same on *mudarabah* to a third party to conduct business. In this regard, Khattab writes, "fuqaha are in agreement that a *mudarib* is not entitled to forward *mudarabah* money to a third party for business" (Khattab, 1998, 58).¹⁶ Naturally, the validity of the two-tier *mudarabah* is questionable.

In Islamic banking, *qardhul-hasan* refers to a zero-interest loan. Under this view, *hasan* is seen as a forgone interest that banks could make otherwise. Calling interest as a *hasan* is problematic because that would mean recognition of interest as legitimate earnings. *Qardhul-hasan* is mentioned in the *Qur'an* at least six times.¹⁷ *Qur'an* uses it to imply spending in the way of Allah because every time it is commanded to "lend *qardhul-hasan* to Allah." So it refers to loans from people to Allah only. In fact, *hasan* refers to the sacrificed principal, not the interest that is sacrificed when a loan is given to Allah. In other words, *qardhul-hasan* is a form of *sadaqah*.¹⁸ It does not represent loans among the people. Therefore, it is suggested, that use of *qardhul-hasan* for zero-interest loans shall be avoided.

The principle of *Hasan-e-ada* (better repayment) refers to reimbursement of loans with voluntary additional amount to the lenders. Paying an extra amount voluntarily on a borrowed sum is encouraged by the prophet who has himself set the precedent by paying more than the borrowed sum (PLD, 1992, 70). Under the Islamic banking practices the voluntary payments have been so institutionalized that they have assumed the status of interest. For example, Islamic banks regularly pay returns on current and savings deposits, like the conventional banks pay interest. Similarly,

Malaysian government regularly pays returns to holders of Government Investment Securities issued on the basis of *qardhul-hasan*. Hence, Islamic banking has assumed the practice of interest in the name of 'voluntary' payments by the borrowers to the lenders.

In sum, all the practices analyzed here being contrary to the Islamic injunctions are of doubtful validity. However, it would be found below that it is a minor problem compared with problems related to the functions of central banks and the banking system as a whole.

Islamicity of Central Banking

Whenever a government runs a deficit, there are two methods to finance it. These are: (i) borrowing by issuance of additional government bonds and, (ii) printing additional high-powered money. The choice between borrowing and money creation is made by the central banks. The central banks issue fiat money that acquires the status of high-powered money. Fiat money is the money that does not represent a claim to any physical commodity but instead is backed by laws that require money to be accepted in all legal transactions (Farmer, 1999, 186). When more high-powered money is issued, nominal money supply grows and that, in turn, increases aggregate demand in the economy. Expansion of money supply through bank advances leads to a situation of too much money chasing too few goods. This excessive demand for goods turns into growth of output and prices. How the increased demand influences the output growth and inflation depends on the elasticity of the supply of goods and services. If the supply is completely inelastic then all the money supply growth turns into equivalent inflation. This is apparent from the classical quantity theory of money (Cobham, 1998, 54-56).

The quantity theory of money can be stated as follows:

$$MV = PQ \quad \dots (1)$$

Where, M stands for quantity of money supply, V for velocity of circulation of money, P for the price level and Q stands for real output. Equation (1) is an identity that shows that quantity of money times the velocity of money must equal to the price level times the real output.

The same equation, in growth terms, can be re-written as:

$$\hat{M} + \hat{V} = \hat{P} + \hat{Q} \quad \dots (2)$$

Equation (2) shows that sum of the growth rates in money supply and velocity of circulation must equal to the sum of growth rates of prices (inflation) and output. Assuming no change in the velocity of circulation, any growth in money supply due to printing action of a central bank will be translated into inflation and growth in output. If all the growth in money is translated into growth in output only, then the increased output is transferred to the central bank. Otherwise the government would get people's property to the extent of the "inflation rate times real high-powered money" (Gordon, 2000, 385). This transfer to the state is called *seignorage*, and is also known as inflation tax. *Seignorage* is defined as the "difference between face value and intrinsic value of money" (Anwar, 1987, 295). It results from expansion of money supply because the real value of currency units held by the public reduces due to inflation. In other words, *seignorage* represents transfer of ownership from the holders of money to the creators of money because of inflation.

Injection of fiat money directly creates *seignorage* (inflation tax) to the government and so transfers real property of unaware

people to the state authorities. Channeling of public funds to the authorities by foul means is in direct violation of Allah's command "do not eat up your property among yourselves by foul means nor channel it to the authorities... wrongfully and knowingly" (*al-Baqarah*, 2:188). Therefore, it is obvious that the institution of central banking cannot be Islamic because it violates the express *Qur'anic* verdict regarding wrongful channeling of peoples' property to the authorities.

Money is whatever people accept as a general medium of exchange. "The prophet of Islam is reported to have said that Allah has created gold and silver to be the natural money"¹⁹ (PLD, 2000, 482). Central banks channel public property to the government coffers by creation of fiat money. As paper money issued by the governments is invalid, it is up to the people to revert to a valid form of money. If people wish they might revert to use of gold and silver as money. In fact, moving from fiat money to gold and silver will also prevent diversion of peoples' property to the authorities by foul means.

Central banks also contribute to accrual of *seignorage* to the commercial banking system when they borrow money from the commercial banks by issuing bonds to meet budget deficit requirements of the state. As governments borrow money on the basis of interest, debt servicing leads to increase in budget deficits. This necessitates, again, issuance of more high-powered money and further borrowing from the banking system.²⁰

Seignorage accrues to the state according to the fiat money created by the central banks. Incidentally the same fiat money, being high-powered money, becomes basis for deposits and *seignorage* for the commercial banking system. In this way, not only central banks themselves violate the *Qur'anic* injunctions; they are also responsible for sowing the seeds for the wrongful growth of *seignorage* that

accrues to the commercial banks. How it happens, is elaborated in the next section.

Islamicity of Commercial Banking System

Banking has grown because of: (i) a fraction of the deposits is kept as reserves to meet withdrawals by the depositors and (ii) acceptance of receipts in lieu of money (Farmer, 1999, 184-87). Suppose²¹ someone deposits \$100 of cash (high-powered money) into the banking system. Assuming that the depositors rarely withdraw more than 10% of their deposits, the bank decides to keep reserves equal to just 10% of total deposits and grants loans equal to the remaining 90% percent of total deposits. This depositing and lending the high-powered money starts the process of money creation by the commercial banks. Suppose the merchant from whom the borrower bought the merchandise redeposits the \$90 into a bank. This raises total deposits to \$190 and the bank again has the \$100 in cash. Keeping 10% of all deposits requires the banks to retain \$19 as reserves, the remaining \$81 can be loaned out by the banks. The banks can continue retaining 10% of total deposits in reserves form and loaning the rest of it. This process can continue until total deposits equal \$1000 and all the \$100 cash (being 10% of total deposits) is withheld by the banks as reserves.

However, four conditions must hold for the banks to turn \$100 of high-powered money into a money supply of \$1000. These conditions are: (i) bank deposits (i.e. checks) must be accepted as means of payment, (ii) Any consumer or business firm receiving a cash or check payment must deposit it back into the banking system, (iii) the bank must hold some fraction (e.g., 10%) of its reserves in the form of cash, and (iv) businesses and households must be willing to borrow whatever amount the banks want to lend. (Gordon, 2000, 428)

The money creation process can mathematically be expressed as follows:

$$D = (H/e) \quad (3)$$

Where, H stands for amount of high-powered money, e for the reserve-holding ratio of commercial banks and D for amount of deposits (that become money supply). The ratio $(1/e)$ is called money creation multiplier. The multiplier tells us by how many dollars the money supply will expand for every dollar of high-powered money deposited into the banking system. Of course, value of the multiplier in reality depends on several factors. However, one principle is obvious: lower (higher) the reserve ratio, higher (lower) the money supply and so the concomitant seignorage for the banking system. For example, if $e = 0\%$ then the multiplier would be infinity. This means that even one dollar deposited into the banking system has a potential to stretch into an unlimited amount of money, at least in theory. That is why the central banks impose required reserve ratio that curtails unlimited power of the commercial banks to create money supply.²²

If $e = 5\%$, then multiplier equals twenty (20). That means every dollar deposited will expand into twenty (20) dollars out of which 19 dollars go to the coffers of the commercial banks. These nineteen dollars accrued to the banking system are referred as *seignorage* in the literature. If the banking system can own 19 dollars for each dollar of deposits then imagine how much of peoples' wealth goes to the coffers of the commercial banks due to entire amount of deposits of high powered money. The expanded money supply resulting from depositing of the high-powered money comes under ownership of the banking system. How much of this goes to each bank depends on the reflux ratio, percentage of each bank's deposits that are re-deposited into the same bank, of each bank

(Jaffee, 1989, 339). This is definitely a wrongful devouring of people's property by the commercial banking system which contradicts the repeated command "do not devour your properties among yourselves through false means" (*al-Baqarah*, 2:188; *Nisaa*, 4:29)

This *seignorage* has two consequences: (i) bankers acquire ownership of the wealth to the extent of the *seignorage* without corresponding delivery against it and, (ii) increased money supply is responsible for increased inflation that causes a havoc in the society.

This *seignorage* would accrue to the banking system even when loans are advanced at a zero rate of interest. Whatever the banks earn in the form of contractual interest or profit is over and above the *seignorage* amount. Would banks advance loans if there were no interest charge on the loans? As the *seignorage* will accrue to the banks even if the advances were made free of charge, the absence of interest would not intimidate banks from lending money because otherwise they will lose their share in the *seignorage*.

Supporters of Islamic banking in the ranks of *fuqaha*, economists, bankers, and others mainly focused on the interest-based transactions as deals between banks and their clients. This outlook, perhaps inadvertently, led to the negligence of the larger issue of the legitimacy of the banking system itself. The banking system representing the institutional arrangements for collecting deposits and making advances in a fractional reserve system is in violation of the explicit *Qur'anic* verdict that forbids devouring of peoples' money in the following words "O' believers, do not eat your properties among yourselves through false means" (*Nisaa*, 4: 29)

Accrual of *seignorage* to the banking system depends on several factors (Gordon, 2000, 428) that are determined by the attitude and behavior of public toward the banks. If there were no

deposits into the banking system then there would be no *seignorage* for the banks. Even if the people deposit but they do not borrow then, again, there would be no *seignorage*. If people borrow but do not redeposit their borrowings into the banking system then, again, there will be reduced *seignorage*. In a nutshell, accrual of *seignorage* to the banking system is in the hands of the public. The banks cannot accumulate *seignorage* if the people do not provide opportunity for it. It is the attitude of people that opens up opportunities for the banks to behave greedily and dishonestly.

Suppose all the money created by the banks is translated into real growth so that there is no inflation and no reduction in the real value of deposits. Then do the commercial banks have any advantage? Yes, because they being the creditors still become owners of the deposits created through this process. Therefore, inflation or no inflation the commercial banks would enjoy undue advantage thanks to the money expansion multiplier process. The government enjoys similar advantage when money supply is increased by the central banks as it acquires ownership of the peoples' property in exchange to the tune of the money so created. The difference being the central banks directly create money while the commercial banks create money indirectly through leveling the deposits.

If all the depositors turn to banks to withdraw their deposits then would they be able to receive back their deposits? Surely not because of the fractional reserve system that grew out of the dishonest practices of the early goldsmiths with whom people used to keep their trusts. Therefore the Allah's orders like "Allah commands you to render back your trusts to those to whom they are due" (*Nisaa*, 4: 58) and "do not misappropriate knowingly things entrusted to you" (*Anfaal*, 8: 27) can never be complied in the presence of the fractional reserve system. Moreover, due to expansion of money supply by the banks, the resulting inflation means that real value of the deposits falls. This means that the

deposits withdrawn from the banks have diminished value. This amounts to a clear violation of not only the above commands but also of those commands that require to “give not short measure or weight” (*Hud*, 11: 84) and “give full measure and full weight” (*Hud*, 11: 85).

Accrual of the *seignorage* to the commercial banks by devaluing the money holdings of people through inflation necessarily favors concentration of real wealth into few hands, an outcome contrary to the *Qur'anic* command that wealth “does not make a circuit among the wealthy among you” (*al-Hashar*, 59: 7). The tendency of concentration of wealth into few hands is due to the *seignorage* that would happen even if the loans were issued at a zero rate of interest. Therefore, credit system imposes a larger problem compared to the practice of interest.

Measures Towards Enhanced Islamization of Banking

It is clear from the above analysis that central banks provide high-powered money whereby they devour peoples' property wrongfully. The high-powered money is the genesis for the deposits made by the people to the commercial banking system. The commercial banks advance those deposits to needy individuals and businesses and so they reap benefits in the form of implicit return (*seignorage*) and explicit return (interest or profit) on their credit. Both types of returns are found to be inconsistent with the commands of Allah. Therefore, further Islamization is needed in: (i) creation of fiat money by the central banks, (ii) creation of money supply by the commercial banks and (iii) elimination of *riba* component from the Islamic banking transactions. Therefore some measures are presented below which, if implemented, would enhance Islamization of banking.

The measures suggested include: (i) the replacement of fiat money with the commodity money by the central banks, and (ii) splitting of all commercial banking activities into two subgroups of investment banks and social banks.²³ This action is meant to reform financing side of the commercial banks for transforming them from mere financial intermediaries to entrepreneurs. These measures are elaborated below.

At the level of central banking, efforts shall be made to revert from the present fiat money standard to the commodity money standards, specifically gold and silver, which prevailed at the advent of Islam. In this regard, the paper money may continue to circulate but it shall be fully backed by gold and silver. Extraneous paper money shall be withdrawn from the economy, perhaps by selling state assets to the public. Adoption of commodity money standards will eliminate the *seignorage* generating role of the central banks. It is a formidable challenge to meet these requirements.

Some writers, like al-Jarhi and Kahf, have proposed 100% reserve requirement for commercial banks to eliminate the *seignorage* generated to them (Siddiqi, 1983, 45). This would mean that the banks would become mere depositories and the money will be hoarded in their vaults. But hoarding of money is condemned by Allah (*al-Humazah*, 104: 1-3). That is why a restructuring of the entire commercial banking system is suggested here along the following lines.

Firstly, it is suggested that all the functions and activities of contemporary commercial banks shall be classified into several types of entrepreneurial tasks so that each class is akin to a business of some industry outside the banking arena. These business houses may be called investment banks. In this way all commercial banks shall be split into various types of specialized investment banks. The investment banks can solicit deposits on the basis of *mudarabah* and *musharakah* for employing the funds themselves into production

and trading activities of their choice. However they shall be barred from extending those deposits to a third party. The depositors shall be duly rewarded with their share in the profits, if any.

Each investment bank may specialize in a suitable productive activity to earn profits by carrying on business in trading, industry, manufacturing, agriculture, leasing and services. In a nutshell, most of the banking operations shall be transformed into usual entrepreneurial business entities. Once the commercial banks operate according to their specialized categories then they would no more be involved in the business of advancing credit to earn *riba*. They will have to use their entrepreneurial expertise, like all other profit-seeking businesses, to earn profits.

Secondly, transform all banking activities of accepting return-free deposits into a single network of social banks under the management of a trust comprising representatives from all walks of life in the society. The network can collect return-free deposits and issue return-free loans for socioeconomic purposes. The representatives would ensure fair distribution and use of credit for meeting essential needs of different segments of the population. However, it would be distinct from the contemporary banking system in several respects like: (i) there will be no *riba* involved in financial transactions on either deposits or loans, and (ii) loans will be issued only to serve identified individual and social needs.

Despite giving return-free loans the social banks will continue to enrich themselves through the *seignorage*. We have noticed that the *seignorage* is result of the inflation resulting from the money supply created by lending activities of the depository institutions. Therefore the *seignorage* would accrue to the social banks as they will be involved in soliciting deposits and advancing loans. Although inflation will be much lower compared to the contemporary banking system. The Social banks can spend the *seignorage* so created to contribute in the direction of observance of

Allah's commands that the funds shall not make a circuit among the rich people.²⁴ The deposits shall be utilized to issue return-free loans to needy people as well as loans to state organs for sake of social projects. In any case, the *seignorage* that is property of the society will be used for development of the society rather than enriching private commercial banks.

Those people who are unable to sustain in the face of inflation, or otherwise, have a right to get financial grants from the social banks. Providing grants and assistance to those individuals who are hurt by inflation from the *seignorage* would be their legitimate right. Main idea of this proposal is to transform the *seignorage* into a form of *sadaqah* so that what is extracted from the society is spent on the society. In other words, society pays and society receives. This is unlike the *seignorage* accrued to the commercial banks that thrive at the expense of the entire society.²⁵

This is a brief exposition of what course of action is consistent with the *Qur'an* and *Sunnah* in the discipline of banking. The views expressed here are undoubtedly drastically different from the views held by contemporary Muslim scholarship. However, it is expected that Muslim scholars will sooner or later realize the truth and make concerted efforts to replace the present banking system with another system that would reflect a faithful observance of commands of Allah and His messenger (p.b.u.h).

Endnotes

- ¹ Incidentally, the current study will demonstrate below how the applications of *mudarabah* and *murabahah* by Islamic banks resemble interest-based banking. If it is accepted that nature of returns to Islamic banks is not different from the interest to conventional banks then all the evils ascribed to interest would remain intact despite changing the conventional banking into

Islamic banking. The list of moral, social and economic evils associated with the practice of interest is indeed very long. See PLD, 2000, 529-537 for a detailed discussion.

- ² In fact, the judgement delivered by a full bench of the *shariah* judges is an authentic document that sums up the present state of theoretical and applied knowledge on Islamic banking. It also contains all shades of opinions expressed by the prominent jurists, bankers, lawyers, statesmen and economists. It covers all issues related to Islamic banking. That is why the current study has heavily relied on it.
- ³ Similar commodities cover both homogeneous as well as differentiated products like dates of all types.
- ⁴ Sometimes the transactions that generate *riba* are also referred as *riba* as seen in the following verse: "Allah has permitted bai' and prohibited *riba*" (*Al-Baqarah*: 275)
- ⁵ Money has the same status in exchange as any other commodity. In other words, money must be a commodity with its own intrinsic value in an Islamic economic system, otherwise recovery of the principal stressed in *Qur'an* (*al-Baqarah*: 275) would be meaningless. A recent *fatwa* has declared that use of paper money is *haram*. See Vadillo for details.
- ⁶ Views regarding prohibition of time value of money differ. Time value of money is a key concept in the financing business. A detailed discussion on the issue of time value of money as *riba* is available in Alkaff (1986).
- ⁷ Mutual willingness is an essential factor in trading. However, exploitation on the pretense of mutual willingness is not allowed. For example, *riba* is prohibited even though it happens with mutual consent of the parties. Similarly, *talqi-jalab*, practice of people of *Madina* to meet farmers outside the town and purchase grain from them was disallowed (Afzal-ur-Rahman, 1975, 44) by the prophet (s.a.w) even though the trading must have been conducted with mutual willingness. A detailed discussion of tenets and injunctions related to trading and

marketing is given in Anwar and Saeed (1996).

- ⁸ The preceding part of the same verse says, "they say, selling is like *riba*". Selling is confused with *riba* transactions because both are income generating exchange contracts. They are reminded that income from exchange of heterogeneous commodities is due to selling but income from exchange of similar (including money) commodities is *riba*.
- ⁹ In exchange activities, earnings accrue to sellers. Therefore, one may focus on selling aspect in exchange as stated in the *Qur'an* while referring to the distinction between selling and *riba*.
- ¹⁰ Please refer to BIMB Institute of Research and Training Sdn. Bhd (1996)
- ¹¹ Compare formulas for computing monthly rentals given on page 10 with the formulas for monthly installments on a *bai bithaman ajil* contract given on page 13. Both formulas are identical. In case of financial lease the commodity is in the control of the customer while ownership is with the bank. In case of *bai bithaman ajil* the customer is the owner but bank keeps the title of ownership as collateral.
- ¹² Qur'an states "O ye who believe! When ye deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully between the parties: and let not the scribe refuse to write as Allah has taught him, so let him write. Let him who incurs the liability dictate, but let him fear Allah and not diminish aught of what he owes. If the party liable is mentally deficient or weak or unable himself to dictate let his guardian dictate faithfully. And get two witnesses out of your own men, and if there are not two men then a man and two women. Such as ye choose for witnesses so that if one of them errs, the other can remind her. The witnesses should not refuse when they are called on. Disdain not to reduce to writing (your contract) for a future period, whether it is small or big. It is more just in the

sight of Allah, more suitable as evidence, and more convenient to prevent doubts among you. But if it is a transaction that you carry out on the spot among you, there is no blame on you if you reduce it not to writing. But take witnesses whenever you make a commercial transaction and neither scribe nor witnesses suffer harm. If you do (such harm), it would be wickedness in you. So fear Allah because it is Allah that teaches you. Allah is well acquainted with all things. If you are on a journey and cannot find a scribe then a pledge with possession (may serve the purpose). And if one of you deposits a thing on trust with another let the trustee (faithfully) discharge his trust, and let him fear his Lord. Conceal not evidence; for whoever conceals it, - his heart is tainted with sin. And Allah knows all that you do. (*Al-Baqarah*, 2: 282-283)

- 13 Fiqh Academy of the Organisation of Islamic Conference (OIC) has permitted such sale on the condition the second sale transaction should be concluded with a party other than the party in the first sale (PLD, 2000, 359). Can this condition be a barrier to exchange of money with money by the banks? Is it difficult for banks to circumvent this condition by indulging a fictitious customer as a third party?
- 14 Collateral is also justified on the pretense that the prophet himself had mortgaged his armor to a Jew. The question is whether the collateral was submitted in lieu of documentation because the prophet (pbuh) was on journey or was it submitted in addition to the documents.
- 15 Figures cited here are taken from an example given in the BIMB Institute of Research and Training Sdn. Bhd. (1996)
- 16 Khattab also notes that *fugaba* allow such arrangement provided the depositor grants permission to do so. This is the basis for recommending two-tier *mudarabah*. Islamic banks do not practice much of it, anyway.
- 17 See *al-Baqarah*: 245, *al-Maidah*: 12, *al-Hadid*: 11 & 18, *al-Taghabun* 17 and *al-Muzammik*: 20.

- ¹⁸ A comparison of the contents of *al-Baqarah*: 261 with any of the verses on *Qardhul-Hasan* assures that *qardhul-hasan* represents nothing but spending (*infaq*) in the way of Allah.
- ¹⁹ A fatwa was issued in Granada that declares "The use of paper money in any form of exchange is usury and is therefore haram" (Vadillo, 1991, 48)
- ²⁰ Central banks also contribute towards limiting of expansion of money supply by the banking system because they require the banking institutions to retain certain percentage of deposits in the form of reserves. Regulations pertaining to reserve requirements limit the capability of commercial banks for expansion of money supply.
- ²¹ This example is adopted from Gordon (2000).
- ²² Imagine what may happen to the money supply if the world adopts a system whereby only electronic money would be used.
- ²³ This can be accomplished like Bank Bumiputra Malaysia Berhad (BBMB) was split into Bumiputra Commerce bank and the Bank Muamalat in Malaysia.
- ²⁴ See al-Hashar, 59: 7 that states "it may not merely make a circuit between the wealthy among you."
- ²⁵ Chapra has argued that "creation of deposits by commercial banks... may be recognised in the Islamic system provided that (a) appropriate measures are taken to ensure that the creation of derivative deposits is in accordance with the non-inflationary financing needs of the economy, and (b) that the seignorage realised from derivative deposits benefits society as a whole and not a vested interest group" (1985, 158). The idea of instituting social banks allows utilization of the seignorage for the benefit of the society as envisaged by Chapra.

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