Reorganization of Islamic Banking: A New Proposal

Muhammad Anwar

Introduction

Traditional banking is rejected by Islamic scholars mainly because of interest. Interest-bearing banking is supposedly being replaced by profit-sharing banking organized on the basis of two-tier *mudaraba*. *Seigniorage* (difference between face value and intrinsic value of money) resulting from expansion in demand deposits will continue accruing to the interest-free banking system. Islamic economists consider it unjust to leave the *seigniorage* in the hands of private banks.

Money experts feel strongly that the *seigniorage* should be transfered to society by financing welfare projects. A dual banking scheme is proposed here that will accomplish this task and contribute towards achievement of some other socio-economic goals of an Islamic society.

The major role of banking for an economy is presented in section I. Interest-free banking is outlined in section II. Dual banking scheme, with its justification and socio-economic implications, is proposed in the final section.

I. General Role of Banking[1]

Economists classify all economic agents into households, business firms, and government.[2] An economic agent must operate within its budget constraint. The budget of an economic unit could be balanced, in deficit, or in surplus for a given period depending on, respectively, whether its income matches its expenditures, income exceeds its expenditures, or expenditures exceed its income. Savings from the surplus economic units (SEU) are transferred to the deficit economic units (DEU) in order to satisfy current investment and consumption needs of DEUs and increase incomes of SEUs for the ensuing

---

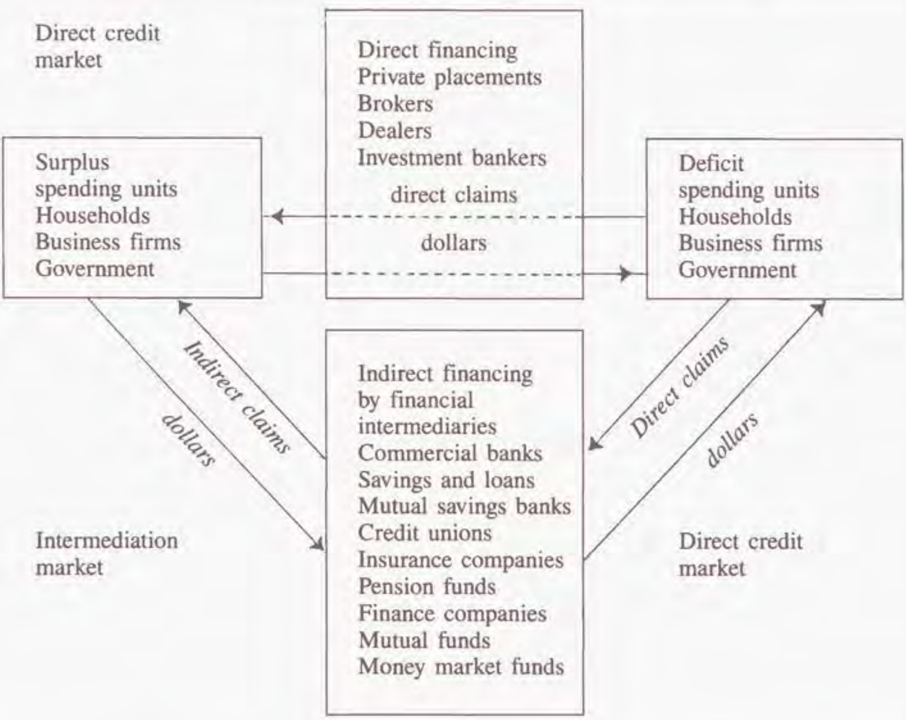
Muhammad Anwar, Ph.D., is a former Research Associate of the International Institute of Islamic Thought, Herndon, VA.

periods. In the transfer process funds are exchanged with financial claims between the surplus units and the deficit units either directly or indirectly through financial institutions as illustrated in exhibit I.

Surplus units deposit their savings into financial institutions which, in turn, are lent out to the deficit units. Financial institutions consist of commercial banks, saving and loan associations, mutual savings banks, credit unions, life and casualty insurance companies, pension funds, finance companies, mutual funds, and money market funds.

The major advantage of a banking system lies in efficiently channelling funds, directly or indirectly, from the SEUs to the DEUs through financial markets. Banks provide four distinct types of intermediation during the exchange process of funds and financial claims: 1) they pool a wide range of small deposits from surplus units in order to finance a wide range of investment and consumption denominations offered by deficit units (called denomination intermediation); (2) they satisfy maturity requirements of both the surplus units and the deficit units; they collect deposits of a wide range of maturities

Exhibit I Transfer of Funds from Surplus to Deficit Spending Units.



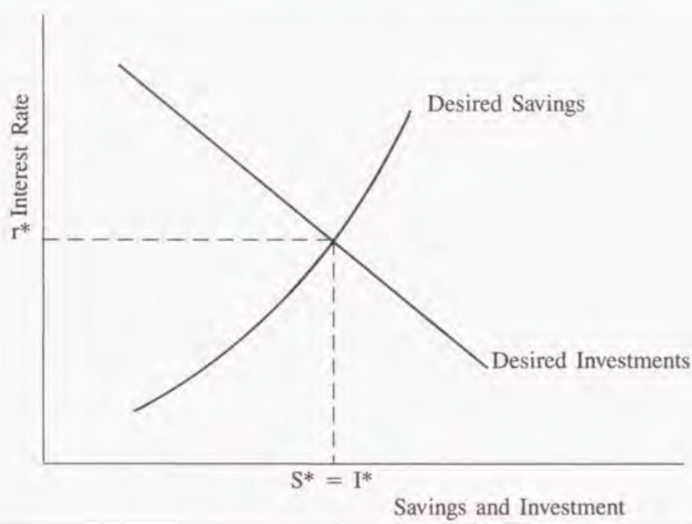
Courtesy: David S. Kidwell and Richard L. Peterson, *Financial Institutions, Markets and Money,* p. 24.

from SEUs and buy direct claims from the DEUs of maturities offered by them (called maturity intermediation); 3) they spread risk for their depositors by purchasing a wide variety of securities (called risk diversification intermediation); and 4) they meet liquidity needs of depositors in order to fill the gap between their income and expenditure streams (called liquidity intermediation). This flexibility in denomination, maturity, risks, and liquidity cannot be achieved by economic units through their individual efforts.

Banks function through regulated financial markets in traditional systems. Household surplus, business surplus (in the form of depreciation and retained earnings), government budget surpluses, and increases in money issued by the central bank of the country represent the supply of funds; and consumer credit purchases, business credit investments, and government budget deficits form the demand for funds in the financial markets. Households, businesses, and governmental agencies are all suppliers as well as demanders of funds. However, households are generally net suppliers of funds while businesses and government are net demanders of funds.

Banks sell demand deposits, savings deposits, time deposits, insurance policies, pension funds, commercial papers, and bonds to the suppliers of funds. They purchase business loans, consumer loans, mortgages, government securities, corporate bonds, corporate stocks, municipal bonds, and money market securities from the demanders of funds. All these financial claims are negotiated on the basis of interest rates in traditional economies. That is, banks pay interest to their depositors and charge interest from their borrowers. An Interest-bearing financial market is illustrated in exhibit II.

Exhibit II Determinants of Rate of Interest



But the practice of interest is prohibited by Qur'anic injunctions and ahadith of Prophet Muhammad (peace be upon him) in most severe terms.[3] Interest-based banking cannot be accepted by Islamic scholars. Muslim economists therefore propose interest-free banking in which interest is replaced by a share of profits. The theory of interest-free banking is outlined in the following section.

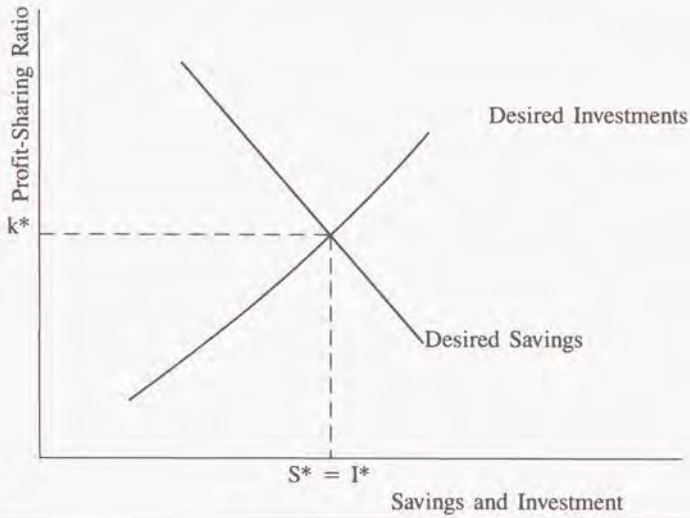
II. Theory of Interest-Free Banking

The Qur'an *(al-Baqarah:* 275) contrasts the practice of *riba* (interest) with commercial selling in order to condemn *riba* and approve trade. Islamic scholars commend trade-oriented banking in place of traditional interest-bearing credit oriented banking. The major vehicle of interest-free banking is a two-tier *mudarabah. Mudarabah* is a business contract negotiated on the basis of profit-sharing ratios between two profit-seeking parties, A and B. Party A provides funds to party B, party B independently manages the business according to the agreed terms, the most important of which, from the banking point of view, is an advance agreement on a ratio in which realized business profits are to be shared. Several techniques of Islamic banking are described in exhibit IV.

Interest-free banking is supposed to operate mainly on the basis of two-tier *mudarabah:* one *mudarabah* between the surplus economic units (depositors) and financial institution in order to replace interest-bearing contracts between savers and banks; and another *mudarabah* between the financial institutions and the deficit economic units in order to replace interest-bearing contracts between banks and ultimate users of funds. Hence banks can negotiate deposits and advances on the basis of profit-sharing ratios. In effect, interest-bearing loans are replaced by profit-seeking investments and *qard hasanah* (loans on zero interest). Interest-free financial institutions can efficiently perform all four types of intermediation after eliminating interest from the system as illustrated in exhibit III. Replacement of interest rates by profit-sharing ratios has profound macroeconomic consequences for labor contracts, inflation, stability, growth, and income distribution."[4]

Banking based on the principles of profit-sharing fulfills the Qur'anic requirements on *riba* by introducing trade-oriented activities in place of credit activities and eliminating interest from the banking system. This is a fine arrangement to channel surplus funds for investments. But problems, as discussed in the next section, persist in handling liquidity under fractional reserve system and *qard hasanah* because there is no return on them.

Exhibit III Determinants of Profit-Sharing Ratio



III. A New Proposal

Banking history reveals that people used to deposit a medium of exchange, especially gold, with goldsmiths for the sake of safety. The depositors would surrender their gold in exchange for a certificate of financial credits (called financial claim) issued by the goldsmiths. The depositors would withdraw their gold (medium of exchange) whenever they wanted to buy commodities. Later people realized the inconvenience of carrying the gold for sake of making transactions, so they started accepting the financial claims issued by the goldsmiths (financial institutions) in lieu of gold itself. Financial institutions were used as trusts for the safety of deposits. It became unnecessary to withdraw gold to the extent that the financial claims were honored as means of payment. Secondly, those depositors who still wanted to withdraw all their deposits would not show up all at once nor would they withdraw all their deposits. Since gold deposits would lie idle in vaults of financial institutions, the goldsmiths started loaning out a fraction of the deposits, on interest, of course, without permission from the owners of the deposits. Most of the loaned out gold was redeposited into financial institutions for the same reasons. In this way financial institutions would acquire ownership rights on the future earnings of the borrowers on the basis of the medium of exchange that belonged to their depositors. In essence financial institutions would become wealthy by retaining only a fraction of the deposits, loaning out the rest of them, and charging interest on loans. This is the fractional reserve system that is prevailing in the contemporary financial system. Virtually all Muslim economists consider the fractional reserve system as unjust.

Let me recall that Muslims are repeatedly reminded, and sometimes ordered, by the Qur'an not to annihilate funds among themselves by unjust means. Instead, they should make exchange only with mutual consent (*al-Nisaa:* 29). The institutional practice of extending loans without the consent of depositors violates this injunction. Therefore let me stress that depositors must be made aware of how their deposits will be used in an Islamic banking system.

Umer Chapra recognizes that the creation of credits, which is an addition to the money supply, provides a "subsidy or *seigniorage*" to banks at the expense of society. Therefore he argues that the "net income arising from derivative deposits should be passed on to the state after allowing for the *mudarabah* share of commercial banks, determined in accordance with an agreed formula. This entire income should be used by the state for social welfare projects, particularly those that benefit the poor." (pp. 92-93)

In principle, most economists would agree with Chapra's position that the *seigniorage* should be used for the welfare of society rather than letting the banking public, privileged borrowers, and bank stockholders appropriate it.

One group is in favor of curtailing the power to create a derived money supply altogether by imposing a 100% reserve requirement on financial institutions. Mahmud Abu Saud, for example, argues that real money is sufficient to take care of all transactions. Abu Saud, S. M. Yusuf, Monzer Kahf, and Mabid Ali al-Jarhi also support the 100% reserve requirement to bar commercial banks from influencing the money supply through the expansion of credit. But Mohammad Uzair and Mohammad Arif oppose the idea of a 100% reserve requirement because, they argue, it will subject financial institutions to unnecessry rigidities.

Alternatively, the power to create credit could be given to the central bank, as suggested by Monzer Kahf and Mabid Ali al-Jarhi. But this means nationalization of the banking industry. This position is rejected because, evidently, nationalized industries are notorious for their inefficiencies.[5]

The challenge of "how to design and run a money and banking system that is in harmony with the nature of Islamic ideology, eliminates *riba,* and helps realize the socio-economic goals of Islam"(Chapra, p. 28) still persists. Let me propose a dual banking system that, I believe, will open new doors to meet this challenge.

Financial institutions should be classified into two independent categories according to the nature of deposits and intermediations: private banks and social banks.

Economic units deposit their surplus funds either for use in a transaction or for the sake of earning profits on them. Therefore depositors turn to banks to satisfy two independent needs.

Some depositors make demand deposits only. The revenues and expenditures of people do not coincide. Demand deposits are made primarily in order to bridge the time discrepancy between receipts and consumption expenditures during the budget period. In addition, it is convenient and secure to make payments with checks instead of carrying currency. When person A writes a check to person B, the ownership of the bank's deposits is shifted from person A to person B. This is how banks provide liquidity intermediation. *Seigniorage* accrues to banks because they expand credits out of demand deposits instead of sticking to the liquidity intermediation only.

It is proposed that this function be given only to social banks. Social banks may be organized by local communities, but, should be authorized by the central bank of the country to manage all sorts of public accounts especially *zakah, sadaqah,* and *auqaf* funds. Social banks should accept all demand deposits and extend interest-free loans to finance welfare projects of their respective communities. On the one hand, people will be encouraged to use banking facilities in Muslim countries, whereas now the banking system is seen with suspicion. On the other hand, social banks will participate in local welfare projects by financing local educational, housing, medical, and other necessities; developing local infrastructure; and creating jobs for the unemployed in their neighborhoods. Surplus social banks may cooperate with deficit social banks after meeting their reserve requirements.

Social banks are unlikely to extend undue credits because of the absence of the profit maximization incentive. Conservatism of social banks in extending loans, compared with the profit-seeking commercial banks, will also help to check inflation in addition to creating employment. Therefore, the organization of social banks for liquidity intermediation will not only transfer *seigniorage* to society but also contribute towards the achievement of several other socio-economic objectives of an Islamic economy.

Other depositors possess funds beyond their consumption needs for the current budget period. They make savings and time deposits primarily to make profits during the budgetary period. These depositors do not intend to utilize their deposits during the current budget period. Since these depositors, by definition, possess resources over and above their current needs, they have an ability to bear risks. Therefore, positive returns are not guaranteed on savings and time deposits in an Islamic society.

It is proposed that savings and time deposits be solicited by the private banks only. Private banks should be organized on the profit-sharing basis outlined above in section II. Savings and time deposits are made for the sake of earning profits. Profits accrue as a result of exposure to risks in business activities. Private banks will either invest these deposits or advance them to the deficit business firms for investment. Private banks may continue denomination, maturity and risk diversification, but not liquidity, functions in order to obtain maximum profits for themselves and their clients. But the private banks may function only like all private business ventures, that is, on the basis of *mudarabah*, *musharaka*, and other profit-sharing schemes. Private banks should be barred from receiving demand deposits. The public should not expect charitable services such as *qard hasanah* from the private banks. The banks will have the same legal status as any other business enterprise. Therefore, savings are closely tied with investments and private banks will essentially become business banks fulfilling the Qur'anic injunctions against *riba* and in favor of trade (*al-Baqarah:* 275 and *al-Nissa:* 29).

In sum, under the dual banking system private banks will continue their usual intermediation activities efficiently although their power to create money will be transferred to social banks. Reorganization of the financial system as outlined above, will transfer *seigniorage* from the private sector to society and will assist in realization of other socio-economic goals as well.

Concluding Remarks

At present up to 85% of advances made by Islamic banks are on a markup basis while profit-sharing finance is insignificant. The dual banking system will widen the scope of profit-sharing schemes. Indexing is another area of concern. The indexing problem will be ameliorated because, 1) under the profit-sharing schemes, real returns to depositors, banks,and investors do not diminish during inflationary environment,[6] 2) inflation would be checked due to conservative loans, and 3) assistance will be available to the needy in an Islamic society.

---

[1]Banking refers to a complete financial system and not merely to commercial banks.

[2]Classification of economic units into three categories is for analytical convenience. In the final analysis behavior of all economic units is reducible into families and individual behavior.

[3]Please refer to Umer Chapra, Appendix I for a convenient review of Qur'anic, Ahadith, and Fiqh positions against *riba*. (See Bibliography.)

[4]Refer to Muhammad Anwar, chapters 5-7. (See Bibliography.)

[5]Refer to Siddiqi, chapter 1, for summary of this debate on reserves. (See Bibliography.)

[6]Refer to Muhammad Anwar, chapter 7. (See Bibliography.)

Exhibit IV

TECHNIQUES OF THE TRADE

Some of the basic financial techniques of Islamic banking have approximate equivalents in Western commercial pracatice, but they often involve forms of participation that banks in the United States or Europe do not undertake, or are prohibited from undertaking. Most of the techniques are known only by their Arabic names. They include:

MURABAHA

The Islamic bank purchases, in its own name, goods that an importer or trader wants, and then sells them to him at an agreed mark-up. This technique is used for financing trade, but because the bank takes title to the goods, and is therefore engaged in buying and selling, its profit derives from a real service that entails a certain—albeit minimal—risk, and is thus seen as legitimate. Simply advancing the money to the client at a fixed interest rate would not be legitimate.

MUDARABA

An Islamic bank lends money to a client—to finance a factory, for example—in return for which the bank will get a specified percentage of the factory's net profits every year for a designated period. This share of the profits provides for repayment of the principal and a profit for athe bank to pass on to its depositors. Should the factory lose moeny, the bank, its depositors and the borrower all jointly absorb the losses, thereby putting into practice the pivotal Islamic principle that the providers and users of capital should share risks and rewards.

MUQARADA

This novel technique allows a bank to float what are effectively Islamic bonds to finance a specific project. Investors who buy muqaradah *bonds take a share of the profits of the project being financed, but also share the risk of unexpectedly low profits, or even losses. They have no say in the management of the project, but act as non-voting shareholders.*

MUSHARAKA

The bank enters into a partnership with a client in which both share the equity capital—and perhaps even management—of a project or deal, and both share in the profits or losses according to their equity shareholding.

IJARA-UARA WA IKTINA

Equivalent to the leasing and installment-loan, or hire-purchase, practices that put millions of drivers on the road each year, these techniques as applied by Islamic banks include the requirement that the leased items be used productively and in ways permitted by Islamic law.

SALAM

A buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed price. This financing technique, similar to a futures or forward-purchase contract, is particularly applicable to seasonal agricultural purchases, but it can also be used to buy other goods in cases where the seller needs working capital before he can deliver.

MUZARA'A

Closely tied to salam *deals,* muzara'a *contracts are sharecropping arrangements by which the landowner allows a tenant to cultivate a plot of land, with both parties sharing the harvest at the end of the season or the year.*

Courtesy: Rami G. Khouri, "Islamic Banking: Knotting a New Network," p. 18.

Bibliography

Anwar, Muhammad. *Modelling Interest-Free Economy: Macroeconomics and Development.* Washington: International Institute of Islamic Thought. 1987.

Chapra, M. Umar. *Toward a Just Monetary System.* Leicester: The Islamic Foundation. 1985.

Iqbal, Zubair and Abbas Mirakhor. *Islamic Banking.* Washington: International Monetary Fund. Occasional paper number 49. March, 1987.

Khouri, G. Rami. "Islamic Banking: Knotting a New Network." *Aramco World Magazine,* May-June, 1987. Pp. 14-27.

Kidwell, S. David and Richard L. Peterson. *Financial Institutions, Markets, and Money.* Chicago: Dryden Press. 1987. Third Edition. Chapters 1-7.

Siddiqi, Muhammad Nejatullah. *Issues in Islamic Banking: Selected Papers.* Leicester: The Islamic Foundation. 1983.

And serve thy Lord until there come unto thee The Hour that is Certain.