

# **An Inquiry into Alternative Models of Islamic Banking**

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*Since the time of publication of M. N. Siddiqi's book entitled Banking Without Interest containing the first-ever comprehensive, consistent, and feasible model of Islamic banking, several theoretical and practical models of Islamic banking have been conceived, instituted, and globally promoted. After the initial academic attempts of conceiving and instituting Islamic banks accomplishing interest-free commercial banking based on a pure financial intermediation model, diverse discourses on nature, scope and operational framework of an appropriate model of Islamic banks have culminated into models of Islamic banks such as Business Bank, Mutual Saving and Investment Association, Islamic Saving Bank, Islamic Investment Bank, Islamic Narrow Bank, and Islamic Universal Bank. Some models, being the latest additions and being generally unknown, deserve to be comprehensively understood, compared and contrasted with the earlier models of Islamic banks. In this background, this research paper synthesizes the published theoretical and the available empirical seminal literature on the subject.*

## **1. Introduction**

The novelty of Islamic banking, introduced as an Islamic counterpart to the arena of traditional capitalistic banking in the first half of the 20th century, has culminated into a banking revolution especially in the contemporary Islamic world, in the form of an institutional transition from the Islamized version of the imported interest-based capitalistic model of the commercial banking into an interest-free Islamized model of the universal<sup>1</sup> banking which is premised in the principles of corporate governance and has universal appeal on account of having its uniquely efficient, equitable, and progressive institutional and operational mechanisms. These spectacular developments have been successful to such a great extent in drawing attention of the western economists that they (e.g., Garcia et. Al., 2004) have initiated a trend of documenting comparisons and contrasts between the capitalist model of universal banking and the model of Islamic banking.

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<sup>1</sup> The scope of the Islamic universal banking is broader than that of the conventional universal banking, which signifies multipurpose banking only, because the Islamic universal banking refers to the interest-free Islamic multipurpose banking in a geographically universal framework.

This paper illustrates the panorama of evolution of the theoretical systemic<sup>2</sup> models and the applied models of Islamic banking in their chronological order. It synthesizes the published seminal theoretical and empirical literature about the alternative models of the Islamic Banking from the point of highlighting the nature of conceptual and institutional transition as well as the distinguishing universal, humane, progressive, developmental, and viable systemic aspects of the movement of Islamic banking.

On the basis of a comprehensive review of the alternative models of the Islamic banking conceived by the Islamic economists, this paper highlights the fact that the system of Islamic banking inherently transcends the sphere of mere Islamic financial intermediation and it inevitably encompasses a universally comprehensive, progressive and equitable systemic design, infrastructure, and framework of Islamic central banking.

## **2. The Rationale for Instituting the Universal Banking System**

The contemporary phenomenal institutionalization of the highly innovative design of Islamic banking is based on the Islamic progressive approach of approving, reforming, and adopting the potentially useful elements/practices/institutions (e.g., trade) of the cultures of *jahiliyah* (i.e., ignorance) of all times (i.e., old & modern) as well as rejecting and eliminating their potentially harmful elements/practises/institutions (e.g., interest).

The conventional institution of the interest-based bank was a financial invention accomplished by a culture of modern ignorance wherein the evil of interest has been as much widespread as in the culture of ancient ignorance prevalent in Arabia before the advent of Islam. The mother of the invention of the interest-based bank was the economic necessity of financial intermediation in an environment of ever-growing complexity of the urbanizing human society in the West wherein the surplus funds of the savers could not be directly transferred to the deficit units on a massive scale due to the persistence of serious problems of asymmetric information manifest in the forms of adverse selection, moral hazard, and transactions costs.

The Western capitalistic economic rationale for the interest-based banking was premised upon the prospective benefits to surplus units emanating from diversification (i.e., benefits associated with the bank's facilities of spreading risks through the pooling of funds), the prospective benefits to the deficit units in the form of reduced transactions costs due to the financial intermediaries (e.g., bank)'s

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<sup>2</sup> Systemic models of the Islamic banking comprehensively portray the overall institutional structure (i.e., institutional structure of the Islamic banking including simultaneously the systemically interacting institutions of Islamic government, Islamic central bank as well as its member Islamic banks and other financial institutions) and the operational mechanism in a progressive milieu of the dynamic Islamic economic system.

capability of broadening the range of financial instruments, denominations, and maturities, and, the prospective benefits for the society at large in the form of increased economic efficiency and the rising living standards within an implicit narrow framework of Western nation state, which had no extra-economic aspects in the context of global political economy. In this background, the benefits and costs of the evolving system of financial intermediation, which was initially<sup>3</sup> designed for stabilizing the financial intermediaries and which inhibited competition as well as barred the household funds from flowing to the most profitable investment areas thereby raising the cost of financial intermediation, have been accompanied by the institutional change on account of financial innovations, changing banking regulations, and, changing preferences of the American public. Consequently, the relative importance of the depository institutions in the process of financial intermediation has sharply declined since 1960 in contrast to the increase in the relative importance of the contractual savings institutions as well as investment intermediaries in the process of financial intermediation. Particularly, the commercial banks and savings institutions have experienced decline in their asset shares in contrast to the sharply increased asset shares of mutual funds, retirement funds, and pension funds in the U.S.A.

After the introduction of the Western institution of interest-based bank in the Islamic regions initially colonized and later decolonized by the Western capitalist countries, the Islamic societies and their intellectuals responded to the challenge of Islamically reforming the interest-based bank in their era of modern ignorance by replicating the strategy of Islamically reforming the potentially useful institution of bank, along the lines of the Islamic reforms introduced in the pre-Islamic ancient era of *jahiliyah*, as well as integrating it within the equitable and progressive macroeconomic framework of the Islamic economic subsystem which is instituted for realizing the Islamic humanitarian goals of human development and empowerment through the accomplishment of equitable growth of output/income/wealth as well as its equitable distribution, full-employment of human and physical resources, economic stability (e.g., price stability etc.) on the

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<sup>3</sup> In the background of the Great Depression of the 1930, American Congress introduced a highly specialized financial system wherein financial intermediaries were locked into specific activities. For example, banks were established, with legal restrictions on creating branches and with interest-ceilings, for taking deposits and advancing short-term loans. Thrifts, which were barred from making business and consumer loans, were forced to specialize in long-term fixed-rate mortgages. Life insurance companies, which were barred from holding significant amounts of corporate stock, were restricted to the issuance of policies and to the purchase of corporate bonds. According to the Glass-Steagall Act of 1933, which separated commercial banking from investment banking, commercial banks were barred from underwriting corporate stocks/bonds as well as from holding common stocks in their portfolios. Similarly, investment banks were barred from accepting household deposits and from making commercial loans.

universal level in the light of the Islamic guidelines available in the Holy Qur'ān and the Sunnah of the Holy Prophet Muhammad (Peace Be Upon Him).

Thus the rationale of establishing the Islamic banks and the overall Islamic monetary/financial system is political as well as economic in scope. The economic rationale for the establishment of the Islamic banks and the Islamic monetary/financial system arises in the context of insulating at least the set of contemporary Islamic countries from their individual financial systems' vulnerability in form of financial contagions and financial crises (e.g., In July 1997, Indonesia experienced monetary crises and the consequent economic crises along with the set of other South-East Asian Countries including Malaysia). Moreover, Indonesian Vice President Dr. Hamza Haz has also pointed to a broader politico-economic scope and rationale of the Islamic banking (Haz, 2004), in the context of the imperative of accomplishing massive Islamic financial intermediation in an Islamic institutional framework which transcends national boundaries of Indonesia, as following:

“Indonesia’s 2002 population is around 212 million people, 178 million of which are Muslims. It is a huge potential for the development of Shari‘ah economy. It is reported in 2002 that there are around 40 million small entrepreneurs, 54 thousand medium enterprises, and 2000 large enterprises. I believe most of them are potential captive market of the Shari‘ah system. Hence, I think, Shari‘ah banks and Shari‘ah financial institutions need to reform their management and organization’s system. They will then be able to cover potential customers with excellent services and reasonably competitive benefits. I put my hope on the Shari‘ah economic system to boost the creation of a “clean” institutional system in Indonesia. The welfare quality of most Indonesians is poor. This is indicated by high number of poor people, excessive social-economic disparity, and high number of the unemployment. I believe that the Shari‘ah economic system will be able to reduce the burden. I wish that the Islamic Development Bank in particular could take part in supporting the effort of poverty alleviation. It is because the number of poor people in Indonesia in 2002 is still around 37 million. Thus, the quality of Shari‘ah credit must be enhanced in order to cover micro, small and medium enterprises. As a consequence, poor people can be directly reached by the Shari‘ah economic system. Certainly, the above-mentioned problems are our obligation to solve. We must be able to create an idealism to manage such challenges and potencies. A task force shall be founded for assisting micro, small, and medium enterprises in relation with poverty reduction.”

Islamic economists and statesmen<sup>4</sup> have been highlighting the rationale and scope of instituting a comprehensive Islamic system<sup>5</sup> of banks and other financial institutions in the original Islamic universal systemic framework, which is broader than the Western limited nationalistic scope of the monetary and banking system, while acknowledging the economic imperative of instituting Islamic financial intermediation in an environment of ever-growing complexity of the urbanizing human society wherein the surplus funds of the savers could not be directly transferred to the deficit units on a massive scale due to the persistence of serious problems of asymmetric information manifest in the forms of adverse selection, moral hazard, and transactions costs.

However, mere awareness, consciousness, and recognition of the imperative of developing politico-economic and banking linkages transcending national jurisdictions are not sufficient for realizing the Islamic goals of development and empowerment of humanity. Even Huntington, who acknowledges (Huntington, 1996) that the concept of sovereign nation states is incompatible with the belief in the sovereignty of Allah and the primacy of *Ummah*, envisages a movement from consciousness to Islamic cohesion and considers the consciousness without cohesion as a source of weakness of Islam (i.e., Muslims). The aforementioned weakness is manifest in the fact that no Muslim country, among the contemporary 57 fragile Muslim nation states formed on an un-Islamic Western model which was left behind by their former Western colonial regimes, had the sufficient power, Islamic legitimacy, and global acceptability which is a prerequisite for assuming the leadership of *Ummah* in the 20th century.

It is in the background of the aforementioned weaknesses of the Islamic countries that all Islamic countries, excepting some Islamic countries, have been entrapped into their own inefficient interest-based systems of narrowest nationalistic capitalistic central banking, accomplished by the policy regimes as

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<sup>4</sup> Former Malaysian Prime Minister has been championing the idea of instituting Islamic Dinar as the unified currency of the Islamic countries. In this context, he has also urged the Muslims to stop trade in US \$ during his trip to Dhaka in the context of receiving an honorary Doctorate of Laws in the convocation of Dhaka University, Bangladesh held on December 19, 2004. Of course, Muslims can stop trading in the US \$ if they have access to a stable Islamic currency, as a viable alternative to U.S. \$, which is required to be made available to them by the Islamic statesmen through their appropriate policy responses in the form of giving up their ever-vulnerable nationalistic monetary policy regimes for instituting a single vehicle currency-based Islamic world-level monetary system. Therefore, an indirect implication of his aforementioned views envisages the culmination of the Islamic central banking system into a unified Islamic monetary regime initially at least for the contemporary Islamic countries from the point of view of empowering and developing all constituents of the Muslim *Ummah* and the whole global human society.

<sup>5</sup> i.e., a network of the world-level Islamic Central Bank, the Islamic banks and other Islamic financial intermediaries as the constituents of a progressive universal Islamic monetary regime.

well as the top bureaucracy recommended by Western powers, that supply national currencies which have been too weak to become generally acceptable as the Islamic vehicle currency. Consequently, neither Muslim public has an option other than the option of trading in the U.S. \$ which is relatively stable vehicle currency nor, due to the aforementioned fact, it is possible for the Islamic countries' central banks to have an autonomous<sup>6</sup> monetary policy.

Due to the absence of any Islamic vehicle currency in the entire set of the official currencies of Islamic countries, even common urban people in Islamic countries like Pakistan are demanding the house rents to be paid in the form of U.S. Dollars and the enormously growing surplus funds of the surplus units of the Islamic countries of the Middle East have been fast transformed into Eurodollars/dollars deposited as well as invested abroad merely because the U.S. Dollar has assumed the vehicle currency status on the global level. As a result, the Islamic world's numerous possessors of wealth (i.e., countries, organizations, firms, and individuals) in the form of U.S. Dollars/Euro-Dollars have always been highly vulnerable because the real worth of their aforementioned wealth is extremely volatile primarily due to the frequent "pre-emptive" U.S. Monetary policy changes which are overwhelmingly conditioned by an ever-growing expansionist strategic agenda of the governments of the U.S. The political economy of the pre-emptive financial strikes of the U.S. is stated (Krugman et. Al., 1994) by Krugman and Obstfeld:

"But at that point, the political factor once again came into play in the big way. Arab members of OPEC accumulated vast wealth as a result of the oil shocks of 1973-74 and 1979-80 but were reluctant to place most of their money in American banks for the fear of possible confiscation. Instead, these

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<sup>6</sup> This fact is illustrated by Patrick Gormely, who authored Chapter 27 International Monetary System in Thomas' book *Money, Banking, and Financial Markets* as following (Thomas, 1997):

"Because the three dominant currencies-the dollar, mark and yen- float against one another, the currency of any fourth country acting to maintain a fixed exchange rate with one of the three also floats relative to the other two. For example, the Saudi Arabian Monetary Agency (SAMA) fixes the riyal-dollar exchange rate. This means that the riyal is fixed not only relative to the dollar but also to all other currencies that are fixed relative to the dollar; it floats relative to the yen, the mark, and all currencies that float relative to the dollar. Saudi Arabia fixes the riyal-dollar exchange rate and allows its citizens free international movement of capital. Consequently, it has no autonomous monetary policy; it adapts its monetary policy to that of the United States."

In addition to the above fact, it is important to note that Saudi Arabia sells oil in the U.S. dollars and Riyal is closely associated with the U.S. \$. Thus, it has become the short-term monetary objective of SAMA to reduce the association between riyal and dollar, by connecting Riyal to Special Drawing Right (SDR), due to its undesirable consequences. Saudi Arabia and all other Islamic countries can avoid the aforementioned problems by instituting the Islamic vehicle currency issued by their common central banking system.

countries placed funds with Eurobanks (in 1979, Iranian assets in U.S. Banks and their European branches were frozen by President Carter in response to the taking of hostages at the American embassy in Tehran. A similar fact befell Iraq's U.S. Assets after that country invaded neighbouring Kuwait in 1990)".

In addition, the use of money as weapon of war has been illustrated by Krugman and Obstfeld in the following statement (Krugman et. al., 1994):

"... And the United States was bombarding Iraq with bogus dinars difficult to tell apart from the real thing."

Such negative outcomes of the capitalistic political economy of central banking system, manifest in the form of further disempowerment of the individual Islamic countries' currencies/economies/people, have also plunged the credibility of the U.S. Dollar as a vehicle currency in the profound ocean of doubts. Al-Habashi anticipated the aforementioned scenarios as following (Al-Habashi, 1999):

"The dominance of the U.S. Dollars simply means that we have to succumb to their demands. Our wealth that we have taken so long to accumulate could be lost within months as has been repeatedly proven in the economic turmoil of East Asian economies. Could we formulate an economic system that is resilient to vagaries of the external economic forces? Could we actually develop a financial system or even an Islamic financial institution that would withstand these external forces?"

Of course, the affirmative answers to Al-Habashi's questions are possible in the institutional framework of an autonomous progressive pan-Islamic politico-economic and monetary regime which can be instituted by ensuring the effective integration of the 57 Islamic states. The aforementioned positive answer in a concrete practical form is an inevitable Islamic imperative in the light of the Islamic juristic principle of dominance of *maṣlahah* Aammah (manifest in the form of restoration, defence, and promotion of intertwined forms of politico-economic and strategic security) of Muslim *Ummah* over the *maṣlahah* of individual/individual Muslim state in the light of *maqāṣid*-al-Sharī'ah.

Keeping in view the prospective usefulness of the Islamic interest-free system of banking/financial intermediation and the inequitable<sup>7</sup>-cum-inefficient outcomes of the legally highly compartmentalized and restricted financial role of numerous

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<sup>7</sup> Siddiqi contends (Siddiqi, 1981), "The institution of fixed interest payment ensures a continuous flow of resources from the debtors, who are many, to the creditors, who are few. In many cases the loan does not result in creation of additional wealth out of which interest could be paid to the lender. This is true of consumption loans and most of the loans to the government. This is also true of some loans to business in so far as the business enterprise concerned incurs losses or ends up with a profit smaller than the rate of interest. In all these cases the institution of interest is responsible for a net transfer of the existing resources from the debtors to the creditors."

types of the capitalistic interest-based banks/financial intermediaries (e.g., commercial banks' role of largely providing short-term financing is bound to have a limited developmental impact in the economy), the Islamic economists have been highlighting the rationale of developing an Islamically reformed banking and financial system for realizing the humanitarian Islamic goal of human empowerment/development and, in this context, they have been contributing models of the Islamic banking system as a whole. In the light of the theoretical models of the Islamic banking system, several innovative experiments of the Islamic banking system have been launched in the 2nd half of the 20th Century.

In short, the rationale of the Islamic banking lies not only in the context of promotion of interest-free Islamic financial intermediation but also in the broader context of instituting progressive universal monetary regime of autonomous Islamic central banking.

### 3. Evolution of the Theoretical Models of Islamic Banking

Since the year<sup>8</sup> of publication of Siddiqi's book entitled *Ghair Sudi Bankari* (Banking Without Interest), containing the first-ever comprehensive, consistent, and feasible model of Islamic banking, several theoretical models of the Islamic banking have been conceived and promoted throughout the whole world. After the initial academic attempts of conceiving and instituting Islamic banks for accomplishing interest-free commercial banking on the basis of a pure financial intermediation model, diverse discourses on nature, scope and operational framework of an appropriate model of Islamic banks have culminated into alternative models<sup>9</sup> of Islamic banks. Several alternative models of the Islamic bank, which are indeed the latest addition to the literature of Islamic economics, are generally unknown in the wider circle of the Islamic economists and, therefore, they deserve to be comprehensively understood. In this background, the following inquiry into ten alternative models of Islamic banking focuses primarily on the task of identifying their nature, salient structural-cum-operational features, and vital systemic as well as functional interrelationships within the human development/empowerment-oriented institutional and policy frameworks of the overall Islamic economy.

Siddiqi, in his pioneering treatise (Siddiqi, 1969) entitled *Banking Without Interest* contributed before the advent of the era of actual establishment of Islamic banks, renders an understandable, popular and practicable outline and exhibition of the model of an interest-free Islamic commercial-cum-central banking operating easily on the basis of principle of sharing of profit and loss. His model is premised in the fact of total prohibition of all forms of interest, including the banking interest

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<sup>8</sup> i.e., 1969 A.D.

<sup>9</sup> e.g., the model of 'business bank (*Banque D'Affaires*)' theoretically conceived by Al-Jarhi, the model of Mutual Saving and Investment Association conceived by Ansari, Islamic Saving Bank etc.



as well as commercial interest, in Islam. He envisages the possibility of the establishment of an Islamic bank by an individual, a group of individual partners, and an Islamic state. However, in the light of the empirical fact that generally the requisite considerably massive amount of capital is contributed by the several persons and that the amount of capital provided by each partner may be equal or different, he conceives the establishment of an Islamic bank on the basis of *al-shirkatul al-inʿan* which refers to the agreement of partnership between either two or among more than two persons to work<sup>10</sup> jointly in an enterprise with their fixed capital contributions,<sup>11</sup> with their agreed upon proportionate share in the profit,<sup>12</sup> and with their share in the losses strictly in proportion to their respective capital contributions in the partnership-based funds mobilized for the promotion of business of the Islamic bank. He recommends that the number of shareholders of the interest-free Islam bank, which is always greater than two, must be kept to the minimum number beyond the number two.

From the point of view of operation, promotion and expansion of business of the bank, it is binding on every partner to authorize the bank to hire the staff (e.g., administrative/executive/clerical staff), hire or purchase other requisites (e.g., buildings, vehicles, and fuel), to acquire additional capital either on the basis of interest-free credit or on the basis of *mudārabah* and to offer interest-free loans as well as monetary investments to the needy individuals and institutions. In the light of the practical experiences showing that it is rarely possible to recover sufficient amounts of money from the shareholders for meeting the liabilities of the bank regarding their depositors and that the central bank supervises as well as controls banks for safeguarding the interests of depositors, Siddiqi acknowledges that the expansion of the business of banks requires the establishment of banks on the basis of principle of limited liability of the shareholders of banks. In his model, major decisions regarding the operations of the bank are conditioned by the mutual understanding of all partners of the bank. In the case of a very large number of

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<sup>10</sup> While in principle each partner has the undeniable right to participate in the actual running of the business, it is not essential that every partner should participate in the management of business of bank.

<sup>11</sup> e.g., any number of shares having a fixed value of Rs. 100,000 can be purchased by each shareholder who would become owner of the bank in proportion to the extent of his assets' contribution to the total investment in the bank. However, the minimum as well as the maximum limits of the subscribed capital may also be prescribed.

<sup>12</sup> In the case of distribution of bank's profits in proportion to the number of shares possessed by a partner, the total profit may be divided by the total investment in the bank for determining the profit in percentage form payable to possessor of each share. In this context, Siddiqi proposes that the distribution of profit should be based on the number of paid-up shares and, in this background, every shareholder must inescapably share any amount of the actual loss of the bank in proportion to the size of his investment in bank's shares. However in case of some partners' participation in the accomplishment of managerial responsibilities, implementation of a formula of disproportionate distribution of profit is quite justified in the framework of partnership.

partners, the power of making decisions is delegated to a Council of Representatives and the day-to-day decisions regarding the routine business of the bank are entrusted to the managers who are appointed and discharged either by partners or by the Council of Representatives.

Because of fact that that the banking activity is a continuous process, Siddiqi considers it appropriate to get accounts of the bank audited annually, to prepare a statement of bank's profits and losses, to make a payment of profits to the partners in case of realizing profits or to notify the partner about the fact of his account being immediately debited by amount of partner's share in the loss experienced by the bank along with the provision for the partner to make up the deficiency of his investment by means of the fresh deposits, to renew the partnership agreement for the next year, and to separately record the account of every year.

The business of the bank includes services rendered in exchange for fee/commission/fixed charges, investment of capital according to principles of the partnership (i.e., *mushārah*) as well as *muḍārahah*, and the free services. The interest-free charged services<sup>13</sup> are an important source of the bank's profit because the income from these services may be greater than their costs for the bank. However, the bank's prime source of income is its service of making the capital available to the economic agents who are interested in accomplishing business according to the principles of either *muḍārahah*<sup>14</sup> or *shirkatul al-inʿan*.<sup>15</sup> In case of completion of the business, the bank may get refunded its increased or decreased capital according to the profit or loss. In the context of the accomplishment of

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<sup>13</sup> Set of the charged services includes facilities of safe deposits, transfer of money through traveller's cheques/bank drafts/letters of credit as well as miscellaneous monetary receipts, obtaining as well as directing the final delivery of commercial goods or other articles, purchase and sale of immovable property on behalf of clients in compliance with Shari'ah, expert advisory services (i.e., services of business/legal consultancy) for businessmen regarding the purchase of machinery, raw materials etc, expert advisory services for account holders, purchase and holding of commercial shares for clients, investment of capital as well as the corresponding receipt of profit on the behalf of clients, and any other Islamically acceptable innovative service resulting from the needs of clients, ingenuity, and progressiveness in the attitudes as well as the methods of the bank.

<sup>14</sup> In case of *muḍārahah*-based investment, the bank is entitled to receive a fixed ratio of the profit, which is mutually agreed upon with *muḍārib* at the time of negotiation of the terms of the contract and which may be varying with the enterprise and with the region, earned from the capital provided to the entrepreneur. However, the bank can fix the different ratio of profit with different entities which are individually categorized as *muḍārib*. If *muḍārahah* results into the loss then the bank bears the entire burden of full loss in accordance with its full share in the joint capital. It is important to note that the short-term loans, which may not be counted with the original capital investment, are required to be repaid before accounting for the overall profit and loss.

<sup>15</sup> In case of *shirkatul al-inʿan*-based investment, a bank is entitled to receive a fixed ratio of the profit, that is mutually agreed upon between the contracting parties at the time of negotiation of terms of the contract.

additional investment by the existing investors in the ongoing business, it is an imperative to clear their accounts, determine their profits or losses, adjust their invested amounts for their respective profits or losses, add together their adjusted sums and their additional investment, and institute a fresh agreement. The bank may withdraw its capital with the willingness of its partner in case of its investment for a definite term as well as for an indefinite term.

Siddiqi opposes the investment of a bank's capital in a business in which the capital procured on the basis of long-term loans is being invested. However, the bank may approve the capital procured on the basis of *muḍārabah* for accomplishing investment as well as the capital procured on the basis of *mushārah* for accomplishing investment.

The Islamic banks may also invest a part of their capital in a certain company's common stock shares, whose profits depend on its degree of success (i.e., the level of profit), which are likely to yield annual profits. They may sell the purchased shares in times of necessity especially for maintaining an adequate level of liquidity.

While pointing to the facts that not only the bills of exchange are becoming rare but also they are being replaced by short-term loans, Siddiqi suggests that businessmen may pay the seller the cost of his goods by taking short-term *muḍārabah* funds from the bank which can accept a smaller share of profit than share of profit accepted by it for the loan of a duration of three months or more than three months. A loss on the sale of their products will be borne by the Islamic bank. It is important to note that his proposed procedure for encashment of bills of exchange is the same as the procedure for obtaining loans from the Islamic bank. In response to the request for cash payment against the bills of exchange along with the application for loan, the Islamic bank may decide to accept the request by paying the whole amount without making any deduction and the nature of this amount will be exactly the same as that of the loan of this amount for the person who is interested in the encashment of the bill of exchange. The lending bank will draw the lent amount at the time of completion of the terms of the bill from the entrepreneur or the manufacturer or their banker. In case of the failure of the issuer of the bill of exchange to pay the due amount to the bank, the bank will recover the cash payment from the person who requested the bank to accomplish the encashment of the bill of exchange.

In addition to the initial capital supplied by the founding shareholders of the bank, the Islamic bank acquires additional capital by inducing the general public to deposit its savings with the bank in the *muḍārabah* account and in a 'loan account'. The bank should keep a small proportion (e.g., 3% or 5%) of the *muḍārabah* deposits as reserves for ensuring the normal return of money to the depositors without a need for the bank to depend on the release of bank capital from its *muḍārabah* business. The entire remaining amount, after keeping aside the

reserves, will be invested and the resulting profits will be spread over the total amount deposited in *muḍārabah* account for determining the percentage of profit.

Holders of the loan account, who are not at all charged by the bank, are privileged to draw cheques as well as transfer their money to other account holders. Similarly, the bank is privileged to have full control on the money as long as it remains in the loan account and it can freely invest it profitably. Moreover, the bank may use the loans obtained from the public as the working capital along with shareholders' share capital and *muḍārabah* capital. However, any profit or loss resulting from bank's investment of the sums of loan account will be borne by the bank and it will have neither positive nor negative effect on the amounts held in the loan account.

Bank is required to reciprocate the receipt of loans without interest by issuing loans to business parties<sup>16</sup> (e.g., industrial enterprises, commercial enterprises, and agricultural enterprises having the needs for provision of short-term loans) without receiving either any remuneration for this service or interest and this facility<sup>17</sup> of the bank should motivate the people, having a sense of public good, to deposit their savings in the loan account instead of hoarding their savings. Short-term loans<sup>18</sup> may be advanced against the production of a security by the borrower in the form of the finished or semi-finished goods, goods in the process of production or in transit, ready crops, commercial shares, certificates of ownership, plant or immovable properties, securities deposited in the banks, and the capital procured either on the basis of loan or on the basis of *muḍārabah*.

The bank loans for consumers may be either in the form of overdraft permitted for a fixed period against a security for the overdraft or in the form of the facility that the prospective borrower, who buys the durable goods on instalments, should give a certificate<sup>19</sup> to the seller about the good sold to him and the seller will encash the certificate from the bank on the basis of his responsibility to secure the payment of instalments until the loan account is cleared. The ratio between loan account and the loans to be advanced is proposed to be 50% which is to be enforced by the central bank and the central bank may change it after consulting the banking experts and the representatives of the business class for equilibrating the demand for and supply of loans.

Bank's expenses of maintaining and safeguarding the loan accounts will be adequately financed either from the expected profits resulting from the profitable

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<sup>16</sup> The borrowers will guarantee the repayment of loan within the scheduled duration.

<sup>17</sup> The extent of interest-free loans advanced by the bank is determined as a proportion of the capital deposited in the bank's loan account.

<sup>18</sup> The stipulated maximum term for such loans must be shorter than the term for which the bank supplies the capital on the basis of *muḍārabah*.

<sup>19</sup> The certificate includes details about the sold good, its total cost, procedure of repayment, and name as well as address of the seller and buyer.

investment of sums of the loan accounts or from the fees determined and imposed by the central bank for recovering only and only the actual expenditure incurred by the bank in the process of providing loans.

The endeavours for the success of a bank in avoiding losses for its *muḍārabah* accountholders, offering the highest rate of profit, and providing the most efficient services with the lowest charges enable it to attract a great number of depositors and, thereby, create an area of competition among the banks which enhances their efficiency. The Islamic banks must compete with the Provident Fund Schemes, Insurance Companies, Housing Societies, etc for providing diverse services to the people and their success lies in extending the range of the offered free services as well as the services offered at the nominal charges. Siddiqi expects deposits in loan account to be much more than the deposits in *muḍārabah* account and assumes the ratio between two types of deposits to be 3:2.

In anticipation that all the account holders do not withdraw deposits simultaneously, the Islamic commercial bank is assumed to keep a fraction (i.e., 10%) of the demand deposits as well as *muḍārabah* deposits reserved as cash without losing its ability to make payments on the demand for withdrawal. In this background, while acknowledging that issuance of coins and currency is the prerogative of only the Islamic state, Siddiqi acknowledges the role<sup>20</sup> of banks in creation of new money called the bank money (i.e., credit) as well as in the reduction of bank money because banks can play an active role in the extinction as well as creation of bank money even within the limits enforced by the central bank and this process is not affected by the assumption that the banking system is based on the sharing of the profit as well as losses.

Siddiqi also envisages the establishment of the central bank, as a non-profit Government bank, by the Islamic state with the Government capital for issuing currency notes, for supervising financial as well as monetary affairs with the foreign countries, and for all monetary matters arising from transactions with the foreign countries. The central bank has also the responsibility of supervising as well as guiding all other banks and implementing the development-oriented monetary as well as the commercial policies of the Islamic state. The cost of the management of the central bank may be financed from the profits resulting from the sale of Government *muḍārabah* Shares as well as Government Partnership Shares. However, this source of finance is neither guaranteed nor completely sufficient. Alternatively, for financing the cost of the management of the central banking, either the central banking may be regarded as an essential public service and it may be financed by the Public Exchequer or an annual fee may be levied on banks exactly in proportion to their annual income.

Siddiqi proposes that the Government as well as all other banks should be the account holders of the central bank such that they can draw loans or finances in the

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<sup>20</sup> Its numerical illustration has also been rendered (Siddiqi, 1969) by Siddiqi.

case of the need. The central bank will monitor as well as improve the macroeconomic indicators, direct capital to the deserving industries and areas of economic development, balance the supply of credit and cash with its demand, and protect the value of national currency from the harmful national and international factors. It will be constitutionally empowered to inform, encourage, guide, advise, and force the commercial banks to formulate their policies according to the national interest and congenial principles which ensure mutual cooperation and confidence among the central bank, the commercial banks, and the public. In this context, Siddiqi also recommends that the banks can temporarily<sup>21</sup> borrow from the central bank sums amounting to certain percentage (i.e., 25%), called ‘borrowing ratio<sup>22</sup>’, of the loans advanced by them by presenting the certificates of the loans to the central bank only and only if there arises unexpected demand on the banks for cash. In case of a permanent increase in the demand for cash, the central bank will advance additional loans to the whole banking system by purchasing shares. For influencing the trends of investments and for controlling expansion of credit facilities in particular directions, the central bank can vary the borrowing ratio<sup>23</sup> for advancing loans against the bills of trade. The central bank can also trade the commercial shares.

In an interest-free banking system, the central bank can control the banking business and the supply of money by varying the reserve ratio as well as the borrowing ratio, by accomplishing preferential use of the borrowing ratio, by trading commercial shares, and by changing the lending ratio. The simultaneous use of the aforementioned monetary instruments can effectively serve and balance the policy objectives relating to the supply of money, the ratio between loan and *mudārabah* capital, and share prices.

Siddiqi has envisaged the exploitation of a critical progressive linkage between the interest-free banking system and the human development and human empowerment-oriented public finance within framework of the Islamic welfare state especially in the contemporary underdeveloped Islamic countries wherein the requisite massive financial resources can not be realized merely from taxation, income from the state properties as well as state production, and profits from state industries/the state-sponsored trade. In the background of his own proposal of only exceptionally using the inherently inflationary facility of creation of new money for the deficit financing in only the extremely difficult situations of natural calamity or war, he points out that it becomes an imperative for the Islamic state to procure some part of the people’s savings on the basis of *mudārabah* and

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<sup>21</sup> i.e., for one week or two weeks or three weeks.

<sup>22</sup> Borrowing ratio is defined as the proportion between loans obtainable from the central bank and the loans advanced by the commercial banks.

<sup>23</sup> e.g., the borrowing ratio may be 30% in case of loans advanced to agriculture and this ratio may be 20% in case of the cotton business.

partnership (i.e., by issuing Government *muḍārabah* Shares<sup>24</sup> and Government Partnership Shares<sup>25</sup>) as well as on the basis of interest-free Government Loans by issuing Government Loan Certificates<sup>26</sup> for financing its development schemes through the vehicle of the interest-free banking system.

Every year, the government should mobilize new capital by issuing new shares from the point of view of not only refunding the capital associated with the older shares whose term has expired but also ensuring the requisite excess of the newly procured capital over the refunded capital for sustaining the progress of the public enterprises. In years of low demand for government *muḍārabah* shares, the government can change profit-sharing ratio for the new shareholders for ensuring higher percentage of profits for them. The government can also partially or wholly exempt the income from profits earned only on the government *muḍārabah* shares from taxes thereby leading the prospective investors to prefer their investment in the government *muḍārabah* to their investment in other areas.

In the interest-free banking system, the commercial banks will be keeping numerous Government Loan Certificates of various terms in their custody in order to maintain their liquidity as well as Government Partnership Shares as secondary reserves which will serve as a source of income for the bank and as a means of liquidity. In case of expecting a reasonable rate of profit from Government *muḍārabah* Shares, the interest-free banks may invest some of their business capital in them. In the case of the date of expiry of the term of Government *muḍārabah* Shares being near the date of the repayment of loan, Government *muḍārabah* Shares can be presented as a surety by the individual or the institution interested in taking loans. From the point of view small savers, Government *muḍārabah* Shares will be a suitable alternative to the *muḍārabah* accounts of the banks. While the above shares and certificates will be used by the Government for the implementation of monetary policy and by the Central Bank as a means for conveying its decisions to commercial banks, the existence of numerous Islamic shares and certificates will serve as a means of convenience and orderliness in the national monetary system.

Report of the Council of Islamic Ideology (CII) recommends the approach of simultaneously remodelling the commercial banking system according to the

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<sup>24</sup> Such shares of the value of Rs. 1,000 or Rs. 10,000, or Rs. 100,000 may be issued along with a maturity date of six months, one year, two years, five years etc. Holders of *muḍārabah* shares will have no role at all either in the policy making or in the running of the business. However, the finance raised from the shares issued in the name of a specific enterprise must be invested only in that particular enterprise.

<sup>25</sup> For starting an enterprise with a capital of 10 million rupees, the state can issue 100 shares such that each share has a value of Rs. 100,000. The state itself purchases 60 shares and the banks as well as individual can buy the remaining 40 shares.

<sup>26</sup> The values of the loan certificates can range from Rs. 100 to Rs. 1 million and their period may be a fortnight, a month, three months and up to 3 years.

Islamic imperatives and Islamizing the society as well as the laws governing sale of goods, hire, lease, loans, trust, partnership, and defalcation etc (CII, 1980). In the context of remodelling the banking system on the interest-free basis, CII recommends the transformation of the operating procedures of commercial banks envisaged to be instituted on the basis of a two-tier *muḍārabah* without requiring any change in the institutional structure of the commercial banks as well as the operating procedures of specialized finance institutions<sup>27</sup> based on the Islamic concepts of *muḍārabah* and *mushārahah*. For example, CII not only proposes the replacement of the interest-based saving deposits and time deposits by a system of variable returns based on the Islamic principle of sharing profit as well as loss but also illustrates the use of the daily product method<sup>28</sup> for computing the capital contributions of the parties as well as determining shares in either profit or loss in cases of saving and time deposits. For the purpose of commercial banking, CII has allowed the commercial banks to charge a commission for providing the services of opening of letters of credit (L/Cs).

For accomplishing the fixed investment financing, CII has allowed the commercial banks to provide financing on profit/loss sharing basis to those parties<sup>29</sup> which maintain the accounts audited by Chartered Accountants, to provide financing on the basis of arrangements of ‘hire-purchase’/ *bay‘ mu’ajjal*/leasing to those parties which maintain accounts without getting them audited by the Chartered Accountants, and to provide financing on the basis of arrangements of ‘normal rate of return’/‘hire-purchase’/‘*bay‘ mu’ajjal*’ (i.e., mark-up)/time multiple counter loans to the small parties<sup>30</sup> which are unable to maintain accounts. However, CII considers it incorrect to use the counter multiple loans by the way of a permanent alternative to the interest-based system.

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<sup>27</sup> e.g., Pakistan Industrial Credit and Investment Corporation, Industrial Development Bank of Pakistan, National Development Finance Corporation, Agricultural Development Bank of Pakistan, Small Business Finance Corporation, Equity Participation Fund, Federal Bank for Cooperatives and other Cooperative Credit Institutions, and Insurance Companies.

<sup>28</sup> The study of the following reference material is recommended for developing an understanding of the relevant hypothetical examples of the aforementioned use of the daily product method:

Council of Islamic Ideology, “Elimination of Interest from the Economy”, In: Ahmad et. al., 1983, pp.167-173.

<sup>29</sup> CII allows the commercial banks to finance their working capital needs either individually and jointly by them or in collaboration with the specialized financial institutions by providing the facilities of cash credit, overdraft, and demand loan under the arrangement of profit/loss-sharing based on the daily products which take into the account the amount of capital and their period of employment such that profit is shared according to any agreed profit sharing ratio and the loss is shared in proportion to the contributed capital.

<sup>30</sup> Banks finance their working capital needs on the bases of either ‘normal rate of return’ or *bay‘ mu’ajjal*.



Despite developing an understanding about the permissibility of *bay' mu'ajjal* under Sharī'ah and about its applicability only to the unavoidable cases (e.g., in case of poor farmers' purchases of seeds, fertilizers and pesticides), CII has not only warned against the indiscriminate use of *bay' mu'ajjal* in anticipation that it may open a back door for dealing on the basis of interest but also advised the least possible use of the Islamically allowed modes of financing other than profit/loss-sharing and *al-qard al-Hasan*.

Moreover, CII encourages the commercial banks to formulate, finance and execute their own new projects either individually or in collaboration with the non-bank financial intermediaries by using the method of "investment-auctioning". In the contracts of the fixed investment financing, CII requires the incorporation of the provision for the banks' role of monitoring the actual performance of the project financed by them from the point of view of safeguarding their own interests.

CII requires the commercial banks to replace the financial assistance provided by the banks to the projects during their gestation periods under the interest-based arrangements of 'bridge-financing' by 'the firm commitment'-underwriting under which the underwriters actually take a part of the equity at an agreed upon price which may be less than the face value of the shares. Moreover, CII requires them to replace the debenture financing by issuing the new corporate security called "Participation Term Certificate" which entitles its holder to claim a share in the profits of the issuing concern instead of receiving a fixed interest. CII permits the commercial banks to provide services regarding the bills of exchange in exchange for an advance payment of commission which varies in accordance with the amount of the bill of exchange and, in this context, any variation in commission according to the period of payment is prohibited by the CII.

Commercial banks can provide financing to retail as well as wholesale businesses (e.g., business of imports/exports) under the already mentioned<sup>31</sup> Islamically reformed arrangements of cash credit, overdraft, demand loans, discounting of bills and opening of letters of credit either in exchange for commission or on the basis of profit-loss sharing.

CII recommends for commercial banks to avoid the practise of generally providing interest-free personal loans. It permits only the provision of interest-free personal loans to the meritorious students by the commercial banks as well as the provision of interest-free personal loans to the deserving individuals of the calamity-stricken areas. For avoiding frequent shifts of deposits from commercial banks with lower profitability to the commercial banks with higher profitability, CII recommends for the nationalized commercial banks to achieve uniformity in

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<sup>31</sup> i.e., the arrangements mentioned in the context of financing of working capital needs of the industry.

the rate of return offered on their deposits by pooling their profits for distribution among the deposit holders.

While instituting certain reforms<sup>32</sup> in the specialized financial institutions, CII's model of Islamic banking system extends the application of the Islamic procedural reforms instituted for the commercial banks to all those operations of the Islamically reformed specialized financial institutions which are common between them. This model of Islamic banking system envisages the continuation of the Islamic central bank's inherent goal as well as the functional responsibility of regulating the monetary and credit system of the Islamic state<sup>33</sup> and fostering its growth in the best national interest from the point of view of securing monetary stability and full employment of national resources by using currency notes, regulating money and credit, acting as a banker<sup>34</sup>-cum-advisor not only of the government but also of the other banks, and performing its duties as the ultimate reservoir of liquidity for the financial and banking system.

While discarding certain monetary instruments, CII's model of the Islamic banking system retains some of the monetary instruments (i.e., State Bank's financial assistance<sup>35</sup> to the commercial banks and other financial institutions as well as the open market operations<sup>36</sup>) with substantial legal-cum-procedural reforms as well as retains most of the conventional monetary policy instruments (e.g., minimum cash requirements<sup>37</sup>, liquidity ratio requirements<sup>38</sup> as the statutory

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<sup>32</sup> CII has also presented details about the Islamic reforms proposed for all the specialized financial institutions of Pakistan (CII, 1980).

<sup>33</sup> i.e., the Islamic Republic of Pakistan.

<sup>34</sup> Banks, the federal government, and the provincial governments can maintain their interest-free accounts instituted at the State Bank. While the provision of finance by the State Bank to banks and other financial institutions is to be instituted according to the principle of profit-loss sharing based on the daily products of their respective amounts, the task of provision of the finance by the State Bank to the federal government and provincial governments will be accomplished on the interest-free basis for enabling them to tide over their temporary fiscal deficits.

<sup>35</sup> e.g., The State Bank can provide a charge-free refinance facility to the commercial banks against their interest-free loans advanced to the government for its social-welfare-oriented commodity operations and prescribe for commercial banks to levy only a service charge on the interest-free loans provided by them.

<sup>36</sup> The State Bank can issue its own variable dividend securities as well as use them for open market operations. The holders of profit-loss sharing securities will share either profit or loss with the State Bank on the basis of the daily products of the sums contributed by the aforementioned parties.

<sup>37</sup> In relation to the amount of default on the part of banks, the State Bank can impose a fine per day.

<sup>38</sup> The related financial requirements may be in the form of banks' holdings of Shari'ah-consistent financial instruments which are approved by the government for the purpose of meeting the liquidity requirements. The State Bank can also impose a fine per day in relation to the amount of default on the part of banks.

obligation of every scheduled bank, overall ceilings<sup>39</sup> on the lending as well as investment operations of the banks, monetary targets<sup>40</sup> for providing finance to priority sectors, selective credit controls<sup>41</sup>, issuance of directions<sup>42</sup>, moral suasion, variations in own profit-sharing ratio in case of the finance provided by the central bank to banks and other financial institutions as well as variations in the maximum/minimum profit sharing ratio with minor legal-cum-procedural reforms. It also envisages the government of the Islamic state to design its fiscal policy in a way which sufficiently reinforces the strength of the Islamic monetary policy in achieving the Islamic imperative of stability in the value of money. For eliminating interest from the international transactions (e.g., trade/aid), it proposes the acceleration of the efforts of the governments of the Islamic countries as well as of the Islamic Development Bank for promoting greater mutual economic cooperation in the contexts of instituting Islamic Countries' Trading Block (ICTB) as well as promoting interest-free intra-ICBT trade/aid.

Al-Jarhi presents (Al-Jarhi, 1981) a development-oriented productivity-based monetary and financial structure for an interest-free Islamic economy wherein the mutually supportive interactions of a model of Islamic banking, the Islamic treasury,<sup>43</sup> and Islamic financial markets culminate into the Islamic financial

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<sup>39</sup> This monetary tool limits the overall credit expansion accomplished by the commercial banks within the estimated safe levels of monetary and credit expansion. In case of a bank's excess of the provided credit over the credit ceiling of the bank, an amount equal to the aforementioned excess is required to be deposited on interest-free basis for a period ending at the time when the bank readjusts its credit according to its credit ceiling. Moreover, a fine in relation to the amount of excess of the bank's credit over its credit ceiling is proposed to be imposed on the bank on account of the bank's act of violating the credit ceiling.

<sup>40</sup> This monetary tool enables the State Bank to realize the Islamic socioeconomic goals of the monetary policy by setting banks' targets of providing small interest-free loans not only for financing the business, industry, and the low-cost housing production but also for financing the fixed investment in the agriculture on the basis of the condition that a bank's violations of the aforementioned monetary targets will be punished by the State Bank through the imposition of a fine per day on the concerned bank in relation to the amount of default on the part of the bank.

<sup>41</sup> e.g., In case of bank financing on the basis of profit-loss sharing, the State Bank can prescribe certain minimum ratios of the own contribution of the parties which are obtaining finances from the bank. Similarly in the case of bank loans advanced against the security of goods and in the case of opening of the letters of credit for importing goods, minimum margin requirements can be prescribed by the State Bank.

<sup>42</sup> e.g., The State Bank can prescribe the maximum and minimum profit-sharing ratio on the investments which are accomplished by banks and on time deposits as well as saving deposits held by the banks.

<sup>43</sup> Islamic Treasury consists of the distributive branch having the responsibility of collection as well as distribution of Zakah, allocative branch having the responsibility of managing the socially-owned mineral resources as well as providing public goods, and the division of

market equilibrium and economic development. Al-Jarhi's Islamic narrow banking model (i.e., core banking model<sup>44</sup>), which is modelled in the tradition of 100% reserve plan, consists of the Islamically reformed central bank, commercial banks, specialized banks, and financial intermediaries. He envisages the function of the management of money supply in the form of not only providing a maximum amount of transaction services to the community according to the transaction needs of society but also ensuring the development of different regions and sectors of the economy as well as the stability of price level. In this model of the Islamic banking, the Islamic central bank has the official authority to create fiat money in the absence of government interest-bearing securities while anchoring the growth of money supply to the growth rate of economy.

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market order having the responsibilities of handling monopolies, ensuring orderly markets, and correcting for externalities.

<sup>44</sup> Conventionally, an equity-based as well as 100% reserves-based system of banking, which is known as "narrow banking" or "core banking", consists of a "narrow bank window" and a "broad bank window" such that both distinct windows offer different products. The first product, called money or deposits, has a 100% backing on domestic or foreign as well as public or private AAA highly liquid securities. The second product includes a subset of alternatives in the form of profit-loss sharing accounts as well as other specific investment funds having similarity with mutual funds. On the liability side of the narrow bank's broad bank window, there are interest-free Profit-Loss-Sharing (PLS) accounts or interest-free mutual fund accounts such that the aforementioned liabilities would periodically share a percentage of the corresponding profits or losses of the asset side of the bank.

Figure I

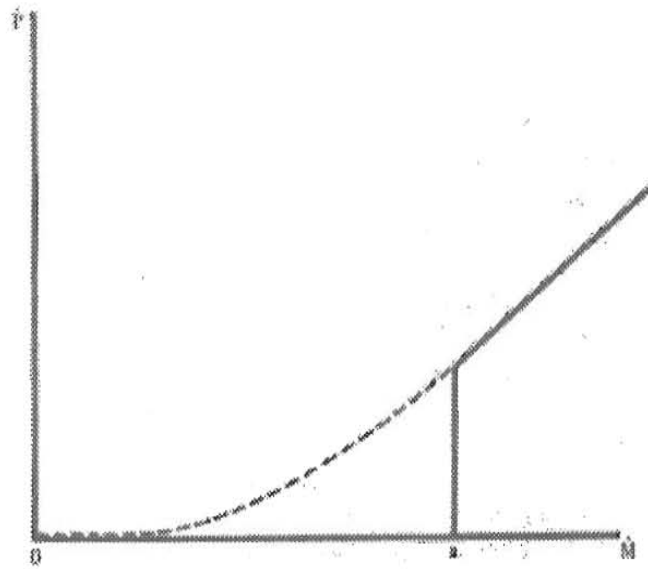
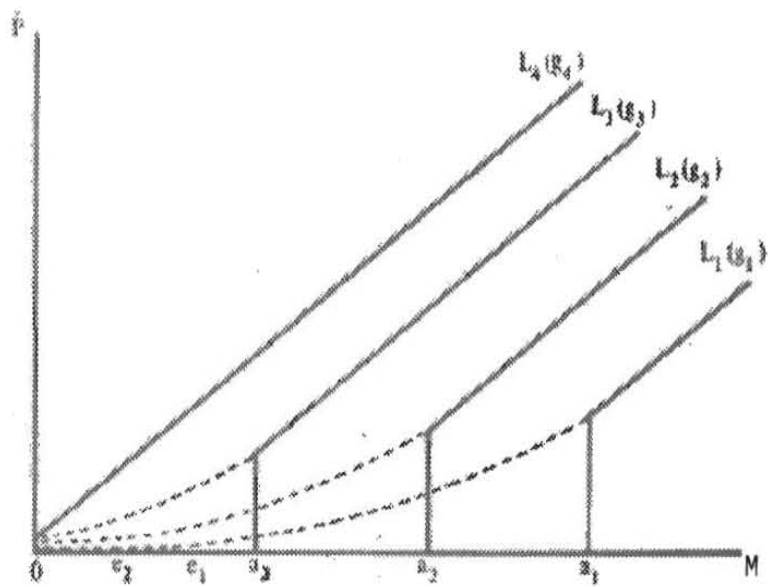


Figure-2



The relationship, assumed by al-Jarhi, between the growth of money supply “M” and the rate of inflation “P” is shown in Figure I in the form of a monetary expansion line associated with the realization of a certain growth rate “g” and in Figure II.<sup>45</sup> The horizontal segment of monetary expansion line, which coincides with the horizontal axis, implies that rates of monetary expansion are too low to produce any inflation for the given rate of real growth of economy as well as state of expectations. After the end of a regime of non-inflationary monetary expansion, higher rates of monetary expansion are going to produce positive rates of inflation in a pattern of progression wherein initially P increases less than proportionately as a result of increase in M and finally increases in M result into equiproportional changes in P. Al-Jarhi asserts that the price stability-oriented Islamic economy should either choose  $M = 0e_1$  with  $g_1$  and  $M = 0e_2$  with  $g_2$  or  $M = 0$ . The Islamic role and structure of the Islamic treasury, having sufficient flexibility in the context of expanding its development-oriented facilities and activities through taxation and *zakāh*, rule out any justification for monetary expansion-based financing of the government deficits and reinforce the Islamic agenda of macroeconomic stability.

Al-Jarhi proposes the realization of the changes in money supply (i.e., increased deposits or withdrawals) through central bank’s investment accounts instituted in its member banks. He requires the member banks to invest central bank’s deposits (CDs) in real sectors according to their investment policies. It is important to note that CDs are used by the Islamic central bank as a tool of the Islamic monetary policy and the Islamic central bank allocates the CDs among its member banks on the basis of the traditional criteria of profitability, liquidity, and risk. Thus, the Islamic central bank promotes investment efficiency in the economy because only the efficient Islamic banks will receive CDs. The profits earned by the Islamic central bank on CDs can be used for covering the costs of the operations of the Islamic central bank. Moreover, the Islamic central bank has the authority to create Central Deposit Certificates (CDCs) as a means of financial intermediation whose proceeds are obligated to be invested in CDs all over the banking system. In this background, the rate of return “ $\rho$ ” on CDCs denotes an average rate of profit on investment for the whole economy.

While radically departing from the structural and operational pattern of the traditional Anglo-Saxon model of commercial banking, Al-Jarhi characterizes a member Islamic bank as *Banque d’Affaires* (i.e., business bank) which undertakes direct investment as a part of its investment activities,<sup>46</sup> provides regular banking

<sup>45</sup> In Figure II, the depicted monetary expansion lines  $L_1(g_1)$ ,  $L_2(g_2)$ ,  $L_3(g_3)$  and  $L_4(g_4)$  correspond to different growth rates  $g_1$ ,  $g_2$ ,  $g_3$  and  $g_4$  (i.e.,  $g_1 > g_2 > g_3 > g_4$ ). In the case of realizing higher and higher rates of growth, there are realized larger and larger segments of the monetary expansion lines along which prices react less proportionately to monetary expansions.

<sup>46</sup> The set of investment activities of the *Banque d’Affaires* includes direct investment, which refers to the bank’s investment in the form of holding shares in the enterprises as

services (e.g., services of demand deposits which are insured against the insolvency of the Islamic bank, selling foreign exchange as well as issuing letters of credit for a fee on the basis of establishment of the Islamic bank's correspondence relationships with the foreign banks etc.) and gets involved in lending activities. Business bank's direct investment in enterprises implies that the Islamic bank uses its expertise, provides technical assistance to them and, thereby improves degrees of their productivity, profitability, and business success because the Islamic bank has the geographic proximity to the financed projects as well as the first hand information about them and the relative familiarity with their managers.

The member Islamic banks can issue Specific Investment Certificates (SICs), General Investment Certificates (GICs), Profit-Sharing Certificates (PSCs), and Leasing Certificates (LCs) which pay out the dividends which are not specified in advance. For the lending activities of the Islamic banks, the Islamic central bank can frame a regulation which requires every Islamic bank to provide a small percentage of its resources as interest-free loans to the deserving economic agents on the basis of certain social criteria. By instituting and selling the interest-free Central Lending Certificates (CLCs) to the rich economic agents of the Islamic economy, the Islamic central bank can provide the proceeds of CLCs to the Islamic banks for augmenting their lending facilities. In this setting, there arise Islamic financial market instruments such as corporate stocks, SICs, GICs, PSCs, LCs, CDCs, and CLCs having a variety of maturities keeping in view the diverse preferences of savers and a country can promote investment and economic growth in certain regions or sectors of the economy through the central bank's role of changing the money supply by adding and withdrawing the CDs and by selling and buying CDCs. Thus, Islamic monetary policy and development policy have become closely intertwined.

Ansari portrays the institutional structure and working mechanism of Islamic banking (Ansari,1983) within the overall dynamic institutional framework of a progressive Islamic system having the family as its basic social unit which has intrinsic progressive linkages with an inherently integrated set of the Islamic institutions including community, community government working under the sacred community leadership symbolized by Imam,<sup>47</sup> regional government, Islamic state, planning organization, mosque, inheritance, *zakāh*/*ushr*/sadaqaat, taxation, domestic/foreign trade, education and vocational training, Mutual Saving and

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well as participating in the their administration, investment in the short-term profit-sharing ventures, and investment in leasing activities.

<sup>47</sup> Imam is the community leader, who leads prayers, having a role which transcends the roles of mosque as well as government, and includes his role in productive investment activities.

Investment Association (MS&I), and Central Monetary Authority (CMA). Families are classified as contractual,<sup>48</sup> non-contractual,<sup>49</sup> and deficit families.<sup>50</sup>

Ansari's system of Islamic banking envisages the establishment of MS&Is and CMA. MS&I is instituted/managed, by the community, to act as a financial intermediary for productive investment in the community as specified and prioritized by the community government. A board of trustees appointed by the community leader has the authority of accomplishing the management of MS&I on the lines of community management of the investable funds in the community, instead of managing the MS&I on the lines of private management which works primarily for private gain, because a community is expected to simultaneously defend/promote the community interests as well as earn profits. Unlike the case of inefficiencies resulting from operation of public enterprises on the basis of "no profit" and "no loss", the community management of MS&I rules out its operational inefficiencies because MS&I works for profit.

MS&I, for earning profit, invests in the *mushārahah/muḍārabah*-based projects of enterprising families/community government/regional government. Profits resulting from the investment-financing activities of MS&I are shared with its depositors according to the agreed profit-sharing ratio. MS&I's share of the profit, owned by the community, is used for financing the community projects which generate the benefits for all. Community management enables MS&Is to realize the benefits of credit creation exclusively for the community gain and the CMA to regulate<sup>51</sup> the MS&Is with greater ease. MS&I solicits, evaluates, and finances investment proposals coming from the enterprising families. It also provides the investment counselling to contractual families. MS&I joins both contractual families to form a partnership or a joint stock company and deficit families for forming *muḍārabah* for creating opportunities for their self-employment. Thus, MS&Is ensure wider ownership of resources and socio-economic justice. MS&Is jointly finance the intercommunity projects under the supervision of regional

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<sup>48</sup> Contractual families are the families which vend their labor in exchange for a contractual reward. They have their propensity to save ranging from zero to a medium value. A marginal contractual family's current expenditures equals its current income. Therefore, the surplus funds (i.e., savings) are generated by all non-marginal families whose positive propensity to save ranges from zero to a medium value.

<sup>49</sup> The self-employed families (e.g., owner-cultivator peasants, practicing physicians, owners of plants and factories, taxi owner-operators, owners of corner grocery stores), called non-contractual families, produce and trade goods and services. Profit are the primary source of the income of the non-contractual families which have their propensity to save ranging from a low value to a high value.

<sup>50</sup> Deficit families (e.g., under-employed, unemployed, widows, orphans, disabled, and aged persons) have their current incomes below their current expenditures. They do not generate any surplus and Islam secures a fair share for them.

<sup>51</sup> For example, in case of community management of MS&Is, it becomes easier for the CMA to sell the State Certificates to MS&Is without any provision of sharing profits.



governments. They change the relative profitability of investment opportunities, which are specified/prioritized by a local authority, by varying the profit-sharing ratios.

CMA, established for formulating and implementing the monetary policy through a board of directors appointed by the Islamic state, effectively regulates the MS&Is by instituting its regional branches wherein its regional directors formulate and implement regional monetary policies in cooperation with regional and community leaders. By varying the deposit-legal reserve ratio, CMA regulates the volume of credit-creation and accomplishes selective credit control. By varying reserve ratios of the MS&Is of various regions, it equitably allocates the credit to the various regions. It allocates the credit to the desired projects and programs by varying the reserve ratios for different types of industries. It varies statutory reserves of MS&Is, kept on *muḍārabah* basis, between the regions and within a certain region keeping in view the marked differences in the demand for funds in regions and communities based on their metropolitan, urban, and rural characteristics. It lends funds to the Islamic state without any provision of profit sharing by buying State Certificates<sup>52</sup> (SCs) and selling them, for nullifying their inflationary impact, to the MS&Is. It buys SCs from the financially stressed regions and communities.

Chapra explores the possible institutional and operational mechanism for accomplishing an efficient and equitable management of the created money (Chapra, 1996). He proposes an Islamic strategy of monetary management to be accomplished through an equity-based financial intermediation which renders the demand for money efficient and equitable and, at the same time, brings the rationalized money demand<sup>53</sup> into an equilibrium with the non-inflationary money supply. He argues that the most practical approach of bringing aggregate money

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<sup>52</sup> SCs are allowed to be used by MS&Is as collateral for getting temporary loans from CMA.

<sup>53</sup> In this contexts, he has introduced the following Islamic money demand function:

$$M_d = f(Y_S, S, \pi)$$

In the aforementioned Islamic money demand function,  $Y_S$  symbolizes the Islamic goods and services related to need fulfillment as well as productive investment,  $S$  signifies all those moral and social values as well as institutions (e.g., *Zakah*) which effectively rationalize the allocation as well as distribution of resources and, thereby, enable the Islamic economy to accomplish its agenda of minimizing the money demand for conspicuous consumption, unproductive investment, precautionary motives and speculative motives, and  $\pi$  refers to the rate of either profit or loss. Chapra expects the Islamic money demand function to be more stable than the Keynesian money demand function especially due to the following factors:

- The contractual stability of the profit sharing ratio, between the entrepreneur and the financier for the duration of contract, and the corresponding stability of expectations regarding the rates of profits
- The stability partially resulting from the absence of interest rates.

supply into equilibrium with the Islamically stabilized money demand is to estimate the money demand and establish a target range for a non-inflationary money supply (i.e., sum of currency in circulation and commercial bank deposits) which can satisfy the money demand sufficiently.

Chapra justifies the treatment of created high-powered money as *Fay'*, because the created high-powered money gives rise to seigniorage and command over resources without effort, and recommends the Islamic goal-oriented allocation of credit, especially for providing the requisite finance to small businesses, on the basis of a loan guarantee scheme, underwritten partly by the government and partly by the Islamic commercial banks, which can relieve the Islamic commercial banks of the need to demand the collateral from the needy owners of the small businesses.<sup>54</sup> He requires the created money to be primarily used for financing the projects which improve the socio-economic conditions of the poor and reduce the economic inequalities. In this context, the Islamic central bank can provide a part of the created money to the government in the form of interest-free loan and a part of the created money to the Islamic commercial banks as well as to the Islamic specialized credit institutions in the form of *muḍārabah* advances which are required to be used for the provision of self-employment opportunities to the poor.

Chapra envisages the existence of an independent Islamic central bank which has the authority as well as the ability of resisting the dictates and demands of the government for providing loans which are incompatible with the imperatives of price stability. Keeping in view the generally recognized close relationship between growth in derivative deposits and the growth in the high powered money in the Islamic commercial banking based on the fractional reserve system, the Islamic central bank is inevitably made responsible for closely regulating the process of growth in the high-powered money. List of the recommended monetary policy instruments includes the statutory reserve requirement only for demand deposits, credit ceilings, government deposits,<sup>55</sup> common pool<sup>56</sup> of deposits instituted for commercial banks at the central bank for solving banks' liquidity problems, moral suasion, use of equity-based instruments of the public sector

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<sup>54</sup> The general credentials of the small businesses are required to be registered with the authorities of the loan guarantee scheme which are also required to certify the credentials of the small businesses.

<sup>55</sup> The instrument of government deposits empowers the Islamic Central Bank to shift the demand deposits of the government to or from the Islamic commercial banks for directly influencing their reserves.

<sup>56</sup> This instrument solves the liquidity problem of the Islamic commercial banks by requiring them to contribute a specific proportion of their deposits to the common pool instituted at the Islamic Central Bank on the basis of cooperative arrangements among them. Any member bank can solve its liquidity problem by getting loan from the facility of common pool on the condition that the net use of this facility by the bank over a given period is zero.

companies for open market operations, and changes in the profit-and-loss-sharing ratio.

International Institute of Islamic Economics (IIIE)'s model of modern Islamic banking system (IIIE, 1999), developed with reference to the commercial banking as an integral part of the framework of a modern Islamic economy, is the latest comprehensive treatise. It views the Islamic bank as an economic agent which accomplishes financial intermediation by simultaneously playing the role functions of partner, seller, buyer, lessor, and provider of interest-free loan in the framework of permissible forms of transactions in Shari'ah which give rise to two distinguishing features of Islamic banking:

1. All financial flows either correspond to real flows or have a check on them due to the partnership-based structure of financing.
2. Despite the possibility of existence of debt in an Islamic banking framework, there is no scope for credit or untied cash in the Islamic banking framework.

In this background, the foundations of the modern Islamic banking operations are defined in terms of trade (i.e., *bay' mu'ajjal* and *bay' salam*)-based arrangements, leasing (i.e., operating lease)-based arrangements, partnership (i.e., *musharakah* and *muḍārabah*)-based arrangements, and interest-free lending arrangements based on the collateral (i.e., *rehn*) and guarantees. In this model, Islamic banks are not expected to opt for pure lending. This model asserts that the options of *amānah* (i.e., safe-keeping), *wadī'ah* (i.e., safe-keeping combined with the option of benefiting from the asset kept for safe-keeping), loan with service charge, charity and *infāq* (i.e., spending for the sake of Allah), *bay' Eeenah* (i.e., buy-back arrangements), *ijārah Wa iqtinā'* (i.e., hire-purchase), and time-multiple counter loans<sup>57</sup> are not relevant to the Islamic banking operations.

On the side of deposits, IIIE's model of the Islamic banking, proposes to institute the current account on the basis of a contract of interest-free loan and, in the context of this current account, a recourse to *amānah* and *wadī'ah* is declared to be uncalled for. In addition, it proposes to institute more than one line of *muḍārabah* deposits as well as perpetual *muḍārabah* deposits and more than one line of *musharakah* deposits as well as perpetual *musharakah* deposits for addressing diverse goals and concerns of the depositors with the provision for existence of differentials in profit-sharing ratios, which must be announced in advance, for different lines of *muḍārabah* deposits as well as *musharakah* deposits. On the side of application of funds, it envisages the use of either only one of the three Islamic modes of financing (i.e., partnership, trading, and leasing modes) or a combination of these Islamic modes of financing for accomplishing financing of consumer goods' purchases, financing of micro enterprises, agricultural financing,

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<sup>57</sup> Time multiple counter loans are not recommended because the ensuing credit expansion is expected to fuel inflation.

project financing, home financing, financing of machinery and equipment needs, financing of working capital, and financing of private investors' equity purchases on the basis of the criterion that partnership modes are used in case of prospects of explicit income flows from the application of funds and, otherwise, trading and leasing modes are used in case of non-explicit income flows from the use of funds.

IIIE's model of the Islamic banking requires the government's prerogative of financing deficits through printing of new money to be exercised, subject to the constraint of maintaining balance between printing money and keeping inflation within 'acceptable limits', only when the public expenditure is justified on the basis of government's discharge of state obligations<sup>58</sup> but neither tax revenue nor any alternative means of financing is available. While highlighting the nature of government transactions related to the financing of the Islamically rationalized<sup>59</sup> budgetary deficits, IIIE's model of the Islamic banking proposes the activation of the institution of Waqf as well as the introduction of divisible as well as tradable trade-related instruments,<sup>60</sup> leasing-based instruments including Asset *ijārah* Securities<sup>61</sup> and Transferable *ijārah* Warrants,<sup>62</sup> and the partnership-based instruments<sup>63</sup> in the Islamic economy.

In the context of elimination of interest from international transactions, it is argued that not only banks can continue to act as an intermediary in matters of collecting and transferring funds and issue a letter of credit according to Sharī'ah requirements in exchange for a fee but also they can satisfy the needs of their clientele by entering into the export and import processes as traders. From the point of view of reducing *ribā* pressures in the arena of settlement of international payments, IIIE's model of Islamic banking system proposes the adoption of IMF<sup>64</sup> model at the level of importers and exporters. For accomplishing central banking, it rejects the idea of 100% reserve requirement for demand deposits as well as the idea of prescribing upper and lower limits for the determination of profit-sharing ratio as a result of negotiations between banks and their clients. It envisages the

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<sup>58</sup> e.g., fulfillment of guaranteed minimum needs of the poor, defense procurement, debt servicing.

<sup>59</sup> In this context, a detailed discourse on the subject of the Islamic reforms and related issues is documented (IIIE, 1999).

<sup>60</sup> e.g., Bay' *Mu'ajjal*-Based Tradable Securities, *Istishnā'*-Cum-Staggered Payment Arrangement, *Salam* Securities.

<sup>61</sup> e.g., Simple Asset *Ijārah* Securities, Asset *Ijārah* Securities involving a financial intermediary, and Asset *Ijārah* Securities, issued by the government itself, for a third party acquiring an asset and leasing the same to the government

<sup>62</sup> e.g., Transferable *Ijārah* Warrants with a finance-lease-transfer arrangement, Transferable *Ijārah* Warrants with a build-lease-transfer arrangement.

<sup>63</sup> e.g., General *Mushārah* Certificates, Decreasing-Participation/Redeemable *Mushārah* Certificates, Special *Mushārah* Certificates against Existing Public Sector Undertakings.

<sup>64</sup> IMF signifies the International Monetary Fund.

introduction as well as operation of control<sup>65</sup> measures as well as regulatory<sup>66</sup> measures for accomplishing central banking and monetary management.

Al-Jarhi and Iqbal's point of view about the special intrinsic nature of the Islamic banking gets crystallized into an Islamic universal banking model<sup>67</sup> (Al-Jarhi et. al. 2001) wherein an Islamic universal bank,<sup>68</sup> portrayed as a multipurpose bank, culminates into a cross-breed of commercial banks, investment banks, merchant banks, investment trusts, insurance institutions and investment management institutions. An Islamic universal bank offers a wide-range of services to its clients on the basis of instituting a long-term bank-client relationship. In sharp contrast to conventional commercial banking model, the Islamic universal

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<sup>65</sup> Control measures include the minimum reserve requirements as well as liquidity ratio requirement imposed only on the current accounts, the reserve requirements applied on the paid-up capital of banks, and the imposition of a minimum share of the capital required to be committed by the banks for ensuring that banks discharge their prospective payment obligations corresponding to the facility of flexible *muḍārabah* deposits as well as flexible *mushārah* deposits instituted by the banks. Moreover, the central bank can prescribe the minimum ratios of contributions of banks and clients in the contracts of partnership. The central bank has also available a control measure in the form of a system of fines for ensuring the compliance of its orders by all the banks.

<sup>66</sup> In the context of the regulatory measures, the central bank has the ability to increase or decrease the volume of liquidity in the system through purchase/sale of the bills of exchange/Shari'ah-consistent tradable instruments held by the banks/new government securities and certificates while complying with the restrictions of Shari'ah. It is important to note that on the regulatory side, the central bank can provide temporary equity support to the deserving banks. However, the central bank does not issue the debt securities against itself. IIE's model of the Islamic banking system envisages the establishment of a high powered Shari'ah Board for ensuring Shari'ah compliance by all participants of the banking system.

<sup>67</sup> The idea of Islamic universal banking model originated in the background of the conventional universal banking which is permitted to be practiced in several countries of European Union.

<sup>68</sup> An Islamic universal bank, instituted as a joint stock company, has the main business of mobilizing funds by taking deposits from savers and supplying these funds to businessmen and entrepreneurs and the scope of its activities includes all the currently known banking activities with the exception of interest-based borrowing and lending. On the liability side of the Islamic universal bank, funds are deposited on the basis of interest-free demand deposits, *muḍārabah* deposits, and *wakālah* deposits (i.e. clients deposit funds in the *wakālah* account on the basis of *wakālah* contract with the Islamic universal bank which serves as the investment manager and charges a predetermined fee in exchange for its managerial services). On the assets side of the Islamic universal bank, finance is provided on the basis of interest-free modes of financing [i.e., *muḍārabah* (passive partnership), *mushārah* (active partnership), diminishing partnership, *murābahah* (sales contract at a profit markup), *ijārah* (leasing), a lease ending in the purchase of the leased asset, *al-istiṣnā'* (contract of manufacture) and *al-istiṣnā' al-tamwili* (financing by way of *al-istiṣnā'*), and *salam*].

banking model offers a wide scope of banking operations especially in the context of authority of the universal banks to follow up and monitor more closely the activities and performances of the enterprises and companies which are financed by them. Islamic universal banks, being partners and stake-holders in the capital of the aforementioned enterprises and companies, have greater capacity of employing various techniques and procedures of monitoring and, therefore, are less amenable to moral hazards. In this setting, Islamic universal banks face less risk than commercial banks in downswings and upswings. The permission of other non-bank activities beyond investment banking is likely to generate further diversification benefits especially when the correlation of returns on diverse activities is sufficiently low. Thus, the Islamic universal banks have an edge in profitability over the conventional commercial banks.

The Islamic model of universal banking envisages the application of legal reserve requirement by the Islamic central bank only to demand deposits while governing other deposits by liquidity ratios and other monitoring indicators. In this model, bank's reserves held at the Islamic central bank will necessarily be placed in the profit-sharing certificates for generating lawful income for the banks as well as using the banks' reserves/profits for enabling the central bank to act as the lender of last resort. For ensuring sound financial conditions of the Islamic banks, the Islamic central bank will enforce financial controls,<sup>69</sup> operational controls,<sup>70</sup> and Shari'ah compliance by instituting a Council of '*ulamā*' at the national level for Shari'ah-audit and for issuing *fatāwā* (i.e., Shari'ah-based opinions).

Khan's model of Islamic banking system (Khan, 2002), while dispelling the point of view that Profit and Loss Sharing (PLS)-based system is the sole Islamic alternative to the interest-based system, illustrates the scope of many Islamically admissible trade-related transactions which conform to the nature of Islamic finance and satisfy the fundamental requirement of Shari'ah that there exist certain assets which are able to either yield return in trading (i.e., *bay'*) and/or in use (i.e., *ijārah*), or create assets which give rise to the flow of income (i.e., profit) which is distributed among the suppliers of capital. This model asserts that the goal of the Islamic monetary policy is to stimulate growth and to ensure price stability. It proposes monetary policy instruments of open market operations in interest-free securities (i.e. PLS securities), reserve requirements, bank sharing ratio, bank/depositor/investor PLS ratios, selective credit controls, and moral suasion. It illustrates that the Islamic central bank's ability to regulate the banking system and

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<sup>69</sup> e.g., capital adequacy ratio, liquidity ratio, profit-sharing ratios among different capital providers, limits to exposure to various types of risks, soundness of the feasibility studies, soundness of contracts, and rules governing banking and financial operations linked to items lying outside the balance sheet.

<sup>70</sup> e.g., the application of consolidated and acceptable Islamic accounting standards, a review of project financing operation, and an evaluation of the performance of banks.

to control money supply is not compromised after elimination of interest from the economy.

Hassan/Farhat/Al-Zu'bi's discourse (Hassan et. Al., 2003) about corporate governance of the Islamic banks and Iqbal/Mirakhor's discourse (Iqbal et. Al., 2004) on corporate governance structure provide theoretical insights into a latest model of Islamic corporate governance-based banking which envisages Islamic bank as an un-levered interest-free financial intermediary working under Sharī'ah according to which Allah (Subhanu Hu Wa Taa'ala) is the absolute owner of wealth and the wealth (e.g., the Islamic Bank and assets of this bank etc.) is entrusted by Him to the mankind as a trust under terms of trusteeship for serving Him. This concept culminates into a unique Islamic corporate culture<sup>71</sup> consisting of numerous stakeholders<sup>72</sup> and the corresponding Islamic corporate governance existing in the Islamic economy and, hence, in the model of Islamic banking.

This model of Islamic banking is based on two principles namely the principle of profit-loss sharing practised through the application of instruments of *muḍārabah* financing as well as *mushārah* financing, which are perceived as equity investments, and the rarely allowed principle of markup which is used for commercial financing in the form of *murābahah* financing and *ijārah* financing. The Islamic bank (trustee) operates an interest-free current account, the saving account on a safe-keeping basis, and *mushārah*-based investment account. In this setting, there arises a basis of the Islamic banking formed by equity participation in real transactions and PLS contract-based risk sharing. The financing on the basis of PLS may create agency problems on the asset and liability sides of the Islamic bank which may be solved within the operational framework of the Islamic corporate governance-based banking model consisting of internal regulatory systems,<sup>73</sup> internal control systems,<sup>74</sup> and external regulatory system.<sup>75</sup>

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<sup>71</sup> The Islamic corporate culture establishes appropriate behavioral standards for all stakeholders, motivates them, governs their internal relations within the organization (e.g., employer-employees relationships) as well as external relations (e.g., dealings with bank's customers), and conditions their internal as well as external environment on the basis of application of the principle of promoting mutual benefits as well as avoiding and eliminating harm for all stakeholders. Thus, all facets of the Islamic bank reflect the Islamic universal values.

<sup>72</sup> In this context, there coexist 7 categories of mutually functionally integrated key stakeholders (i.e., shareholders, management, *mushārah*-financing parties, partners in *muḍārabah*-based investments, current account holders, employees, and Islamic community).

<sup>73</sup> Constituents of the internal regulatory systems are board of directors, non-executive directors, audit committee, internal audit, Sharī'ah supervisory board, and judicial advisor.

<sup>74</sup> Constituents of the internal control systems are financial controls, operational controls, audit reviews, compliance with reporting standards, and Sharī'ah compliance.

Big individual equity holders, who form the board of directors of the Islamic bank, and the equity shareholders are insiders of the Islamic bank and *muḍārabah/mushārah* account holders (i.e., investment depositors) are outsiders such that the investment deposits are contributing 71% of the total capital and equity is contributing 14% of the total capital. Therefore, managers optimally invest all investment deposits from the point of view of outsiders and use dividends to signal their bank profitability to depositors for maintaining the level and inflow of investment deposits. The imperative of signalling the profitability and its stability to the depositors restricts managers' investment activities to short-term and medium-term-investment projects only because of the highly risky and unstable nature of returns in the long-term investment projects. In short, the Islamic corporate governance-based banking model addresses the concerns of all stakeholders (i.e., insiders and outsiders).

Anjum presents a design of a progressive pan-Islamic monetary model (Anjum, 2004) by outlining its systemic goals, rationale, politico-economic framework, the nature/scope/benefits/costs of the proposed Islamic monetary unit (Islamic) Universal “ $\Psi$ ”, and the Islamic monetary management framework consisting of Islamic monetary agency, member banks, demand for money function, the Islamic money supply rule of eliminating monetary hardships through *Shūrātic* (i.e., Islamic consultative framework) process, money supply function and the Islamic monetary transmission mechanism. He envisages the Islamic monetary regime aiming at the development of all humans of all regions in the light of five fundamental progressive objectives (*maqāṣid*) of the Islamic system namely security and advancement of life, religion, intellect, offspring and wealth. He lists the Islamic monetary regime's goals (i.e., the progressive needs<sup>76</sup>-fulfilment for human development from the point of view of improving living standards, equitable economic growth/distribution, full-employment, and price stability as the goals<sup>77</sup> of the Islamic monetary system) which are to be prioritized through Muslim *Ummah*/grassroots -level *Shūrātic* process and realized through the practise of the Islamic progressive principles of politico-economic autonomy for self-reliance, justice, benevolence, and elimination of monetary as well as economic hardships.

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<sup>75</sup> Constituents of the external regulatory systems are shareholders, external auditor, stock exchange, company law, central bank/financial regulator, and the Islamic accounting standard board.

<sup>76</sup> The Islamic approach of satisfying the human needs, keeping in view the available resources, follows the prioritized pattern of basic necessities of life, necessities of efficiency, and legitimate comforts/ beautifications of human life.

<sup>77</sup> Goals of price stability, full-employment-oriented growth, and provision of an optimal level of transactions services in the framework of a growing economy are inevitably ranked highest among the goals of the Islamic monetary regime. These highest-ranking goals are necessarily to be achieved through a non-inflationary monetary expansion corresponding to the segments of monetary expansion lines coinciding with horizontal axis in al-Jarhi's Figure I and Figure II (Al-Jarhi, 1983).



Anjum observes that the most relevant politico-economic framework conducive for establishing a progressive pan-Islamic monetary regime is embodied in the Islamic universal institution of Khilaftul-Khulafa (i.e., government of all governments) envisioned by Shah Wali Ullah in his theory of stages of socio-economic development. In the final stage of socio-economic development, human society and the institution of government assume international character and, as a result, there appears a need for instituting Khilaftul-Khulafa<sup>78</sup> in the context of safeguarding<sup>79</sup> the socioeconomic interests of different states and establishing peace and justice among them. He argues that the existing vacuum<sup>80</sup> in the area of a vehicle currency justifies the contemporary 57 Islamic countries' proposed common policy action of simultaneously abolishing their weak individual currencies and jointly instituting as well as promoting an official Islamic vehicle currency<sup>81</sup> (i.e.,  $\Psi$ ) for ensuring the preservation, development, autonomous control and utilization of their own colossal wealth through the promotion of their progressive pan-Islamic global monetary regime instituted for guaranteeing the politico-economic empowerment of all humans on the global level. The aforementioned common policy action of all the Islamic countries is expected to reduce the practically avoidable huge costs of economic inefficiency<sup>82</sup> (e.g., transaction costs/calculation costs etc.) in the monetary and real sectors of the economies of the Islamic countries. Thus, the pan-Islamic monetary integration is destined to significantly increase the human welfare by reducing

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<sup>78</sup> Keeping in view the prevalent universal consensus on the sanctified status of al-Haramain al-Shareefain among all Muslims of the entire globe, all the contemporary Islamic countries may get completely integrated under the Islamic Caliphate as well as the Khilaftul-Khulafa headed by an Arabian Khaadimul Haramain al-Sharifain in order to meaningfully revive the unparalleled power of Muslim *Ummah*.

<sup>79</sup> Keeping in view the latest invasion of Iraq by the U.S.A. and the U.K. without any legal approval of the United Nations as well as the future possibilities of preemptive strikes of the West against other Islamic states, the simultaneous establishment of *Khilāfat-ul-Khulafa* as well as development of a pan-Islamic progressive monetary regime seems to be the only viable mechanism for the politico-economic autonomy, security and development of the contemporary Islamic world.

<sup>80</sup> Unfortunately, this vacuum is due to the failure of the governments of the individual Islamic countries in providing the urgently needed alternative vehicle currency.

<sup>81</sup> Enormous numerical strength of the global community of over 1 billion Muslims, who will stop trading in the U.S. dollar as well as give up their individual holdings of the US dollar as a vehicle currency in order to hold their own Islamic vehicle currency " $\Psi$ ", is expected to reinforce the strength as well as the confidence commanded by  $\Psi$  not only within the boundaries of *Khilāfat-ul-Khulafa* but also in all other parts of the globe due to Muslims' overwhelming trade and financial linkages with the humanity living all over the globe. Consequently,  $\Psi$  has the potential to assume the character of a truly universal currency.

<sup>82</sup> Such costs of economic inefficiency are experienced in the form of losses of time, effort, and real resources corresponding to the mutual exchange of 57 currencies of individual OIC-member countries.

risk/uncertainty/vulnerability, by generating monetary efficiency gains, and by eliminating the costs of conversions of one Islamic country's currency into another Islamic country's currency borne by traders and investors.

The Islamic progressive monetary regime will have a distinguishing feature of accomplishing optimal monetary management in the dynamic framework of a growing Islamic economy wherein the real money supply is increased in order to ensure the efficient provision of maximum possible amount of transaction services to all economic agents such that the real money supply gets equilibrated with the estimated demand for money along with the successful realization of the already mentioned Islamic macroeconomic goals.<sup>83</sup>

Islamic Monetary Authorities Network (IMAN<sup>84</sup>), proposed to be constituted by *Khilāfat-ul-Khulafa*, will accomplish progressive monetary management in the framework of a pan-Islamic universal economy. The list of constituents of the optimal Islamic monetary management regime includes IMAN including Islamic treasury<sup>85</sup>, Islamic Consensus-Based Banks (ICBBs<sup>86</sup>), Islamic money demand

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<sup>83</sup> i.e., price stability, growth, full-employment, equitable distribution, and human development.

<sup>84</sup> IMAN is proposed to be an autonomous central monetary authority which has the ability to regulate the activities of member Islamic banks and financial institutions. Only IMAN is authorized to create and supply Universals '  $\Psi$  ' to the member Islamic banks, member governments, member private sector development companies, corporations, voluntary sector's institutions, micro-enterprises, and households for financing socio-economic development-oriented projects on the basis of *mudarabah* and *musharakah*.

IMAN, with its head-quarters located at Makkah al-Mukarramah, will be having its regional and local offices for ensuring optimal monetary management at grass-roots level through a comprehensive and efficient mechanism of consulting all types of the relevant economic agents as well as for monitoring/participating in *musharakah/mudarabah-based* productive investments of all relevant economic agents. The aforementioned productive and progressive role of IMAN is expected to ensure the balanced development of all regions, sectors and segments of the society and economy. In this setting, the rate of return on IMAN's *mudarabah/musharakah* approaches the average rate of profit of the entire economy. An increase in rate of return on IMAN's *mudarabah/musharakah-based* ventures is expected to increase the prices of shares ( $P_s$ ) and vice versa. IMAN is envisaged to supply money to government, firms, Islamic banks, and the needy households in the form of *al-qard al-hasan* from the point of view of eliminating economic hardships of all the concerned people.

It is important to note that IMAN's money supply function, which addresses the genuine dynamic monetary needs of all microeconomic and macroeconomic agents of the pan-Islamic universal economy, resembles heart's comprehensive function of supplying only the actually needed quantity of blood to all organs of human body as well as withdrawing the undesired blood.

<sup>85</sup> Islamic treasury may issue a small amount of currency in the form of all coins.

<sup>86</sup> ICBBs are modeled along the lines of Islamic consensus-based banking which is explained in this paper's content # 6: Policy Recommendations.

function<sup>87</sup>, and the Islamic money supply function<sup>88</sup> which is equilibrated with the aforementioned Islamic money demand function, and a progressive Islamic monetary transmission mechanism.<sup>89</sup> It is important to note that IMAN has not the complete discretion in the context of expansion of money supply because it will have to abide by the Islamic money supply rule of eliminating monetary hardships and facilitating growth-based real transactions through an Islamic *Shūrātic* (i.e., consultative) framework. Thus, the Islamic money supply rule will be positioned in between discretionary monetary policy and Friedman's rule of adopting a fixed annual rate of growth of money supply "M". IMAN will estimate the demand for money and then the estimated demand for money will be targeted to be equilibrated

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<sup>87</sup> Following is the proposed Islamic money demand function, based on the Islamically rationalized money demand ( $M_d$ ) for progressive need fulfillment-oriented goods and services which are meant for consumption and productive investment in the framework of a progressive Islamic economy:

$$M_d // P = f(Y_{PIBHGS}, y_m, I, T_F)$$

The aforementioned  $M_d // P$  denotes the demand for *real money balances*,  $Y_{PIBHGS}$  refers to Progressive Islamic Basket of the need fulfillment-oriented *Halal* Real Goods and Services meant for consumption and productive investment,  $y_m$  stands for the rate of return on IMAN's *muḍārabah/mushārah*-based investments of shortest maturity,  $I$  indicate the Islamic institutional factors (e.g., *shūra*, *zakāh*, *taqwah*), and  $T_F$  symbolizes the state of financial technology (e.g., the innovative use of debit cards).

<sup>88</sup> IMAN's money supply function is stated below:

$$M_s/P = f(Y_{PIBHGS}, y_m, I, T_F)$$

Here  $M_s/P$  denotes the supply of *real money balances*. It is important to note that IMAN's money supply is intrinsically directly linked with the really productive economic activity, employment, real income and prices. Therefore, systematic variations in money supply may have systematic impact on the real variables.

<sup>89</sup> The Islamic monetary transmission mechanism functions in the interest-free framework of a universal Islamic economy which consists of four sectors called households' sector, private investors' sector including Islamic banks and financial institutions as well, central/regional/local governments, and the voluntary social welfare sector. IMAN will be directly interacting with all the constituents of the aforementioned four sectors. IMAN will accomplish optimal monetary management for providing greater optimal real transaction services in the progressive universal environment of a growing Islamic economy.

While continuously practicing the Islamic principle of non-inflationary finance, IMAN shall satisfy the Islamically rationalized demand for money of all the aforementioned four sectors on the basis of either *muḍārabah/mushārah* or *al-qard al-ḥassan*. In this background, due to IMAN's policy of accomplishing non-inflationary monetary expansion, the resulting increase in aggregate demand would lead to a growth in the output and income through the multiplier mechanism (i.e., an increase in  $M$  induced by an increase in money demand for accommodating additional transactions of the actually grown output in the framework of a growing universal Islamic economy  $\rightarrow$  increase in  $y_m \rightarrow$  increase in prices of shares  $\rightarrow$  increase in both consumption expenditures and productive investment  $\rightarrow$  increase in GDP of *Ummah*).

with supply of base money alone<sup>90</sup> for satisfying the following monetary equilibrium condition:

$$M_d/P = f(Y_{PIBHGS}, y_m, I, T_F) = M_s/P$$

#### 4. A Retrospective on Applied Models of Islamic Banking

The revealed Islamic guidelines regarding the prohibition of *ribā*, the corresponding imperative of eliminating *ribā* from all economic transactions, and the inspiration provided by the pioneering theoretical models of the Islamic banking have led to the establishment as well as spectacular growth of a variety of applied models of the Islamic banking and financial institutions, whose nomenclature is the Islamic replica of a number of capitalistic models of banking and financial institutions spread all over globe. The following overview of certain practical models of the Islamic banking is expected to be useful in appreciating the structural and operational innovations which have been introduced in the Islamic banking and financial industry overtime and which may be a subject of an objective critique with reference to the degree of their consistency or inconsistency with certain pioneering theoretical models of the Islamic banking. In contrast to Siddiqi's commercial banking-oriented pioneering theoretical model of the Islamic banking, the first practical model of the Islamic banking assumed the role of an Islamic saving bank in the form of establishment of Pilgrims Savings Corporation, which was incorporated in 1962 and which successfully culminated into an Islamic Saving Bank in 1969, and Mit Ghamr Savings Bank in Egypt's rural area of the Nile Delta in 1963. Afterwards a number of the Islamic banking/financial institutions emerged and some of these, about which documents are available, are listed below in a chorological order:

1. Islamic Development Bank (Islamic development finance institution established in 1975)
2. Dubai Islamic Bank (Islamic commercial bank established in 1975)
3. Faisal Islamic Bank of Sudan<sup>91</sup> (Islamic commercial-cum-investment bank established in 1977)
4. The Kuwait Finance House<sup>92</sup> (Islamic public shareholding company incorporated in 1977 and registered as Islamic bank in 2004)
5. Bahrain Islamic Bank (Islamic commercial bank established in 1979)

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<sup>90</sup> This scenario originates from the proposed elimination of the power of banks to create inside money in the Islamic economy.

<sup>91</sup> Faisal Islamic Bank of Sudan established two subsidiary companies namely Islamic Insurance Company and the Islamic Trade and Services Company. It has been supervised by the Shari'ah Supervisory Board.

<sup>92</sup> A financial institution, established in 1979, providing all sorts of services with *murābahah* as its main activity

6. Jordan Islamic Bank for Finance and Investment (Islamic investment bank, established in 1979, having 13 branches)
7. Islamic Investment House (Jordan's Islamic finance company established in 1981)
8. Al-Barakah Investment and Development Company<sup>93</sup> (Islamic holding company of 10 other institutions established in Jeddah in 1982)
9. Tadamon Islamic Bank of Sudan (Islamic commercial bank established in 1981)
10. Islamic Bank Bangladesh Limited (Bangladeshi joint venture multinational Islamic commercial bank established in 1983)
11. Al-Barakah Bank of Sudan (Established in 1984)
12. Qatar Islamic Bank (Islamic commercial bank established in 1983)
13. Bank Islam Malaysia Berhad (Malaysian Islamic commercial bank established in 1983)
14. Amānah Mutual Funds (American Islamic mutual<sup>94</sup> fund established in mid-1980s)

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<sup>93</sup> The main Investment Company of Al-Barakah Group has been based in Bahrain. The capital available to companies of the Al-Barakah group makes it less dependent on private and small depositors.

<sup>94</sup> Mutual funds, being an example of a securities-based assets-to-liabilities scheme, are financial intermediaries. Mutual funds receive a commission or a fee for providing the service of pooling savings of several investors and channeling them directly into assets having an infinite variety of securities including treasury bonds, stocks, and international bonds/equities. In the mutual funds, every investor has an account reflecting instantaneously and simultaneously the value of his holdings as well as the net "liability" of the mutual funds (i.e., the financial intermediary) toward the investor after subtracting the corresponding commission.

Now, there is being observed a global shift toward a mutual fund system. Mutual funds, which have already accumulated assets having a value of more than \$ 4 trillion, are going to overtake the system of traditional banking system as the preferred system of financial intermediation for savers in the future because of the flexibility, transparency, and investors' control over their finances offered by the mutual fund accounts to the individual investors. The mutual funds system, in which the financial intermediary assumes the role of competing for attracting investors just like a retailer, results into a reduced role for the government because the mutual funds can be conveniently globalized (e.g., mutual funds interested in selling a global equity fund can easily draw on its existing funds from different regions of the globe.). In this background, a U.S. equity fund, a Latin American Fund instituted at New York, an Euro fund instituted at London, and an Asian fund instituted at Hong Kong can join to create a new fund called 'Global Equity Fund' containing all the aforementioned funds. In the system of the mutual funds, individual investors are more involved in monitoring the performance of their investments and, simultaneously, the mutual funds are inspired to be more responsive to the demands of investors.

15. Ansar Cooperative Housing Corporation Limited (Canadian Islamic cooperative corporation established in 1986)
16. Al-Rajhi Company for Currency and Exchange, Riyadh (Saudi Arabian Islamic commercial bank licenced to operate in 1989)
17. OBUs<sup>95</sup> [i.e., Five Non-Saudi Islamic banks<sup>96</sup> (e.g., Faisal Islamic Bank of Bahrain), domiciled in Bahrain and Kuwait and operating in Saudi Arabia outside the direct authority<sup>97</sup> of Saudi Arabian Monetary Agency]
18. Islamic Investment Bank Limited (Pakistani Islamic investment bank established in 1990)
19. Bank Muamalat (An Indonesian Islamic commercial bank established in 1991)
20. Abu Dhabi Islamic Bank (UAE's Islamic universal bank established in 1997)
21. Meezan Bank Limited (Pakistan's Islamic bank initially incorporated as an Islamic investment bank in 1997 and then licenced as the first Islamic commercial bank in 2002)
22. Bank Muamalat Berhad (Malaysian Islamic bank established in 1999)
23. Bank Shari'ah Mandiri (Indonesian Islamic commercial bank established in 1999)
24. Amānah Mutual Funds (American Islamic mutual fund established in 2001)
25. Islamic Bank of Britain (Islamic commercial bank established in 2004)

### **5. A Comparative Systemic Critique of the Alternative Models of Islamic banking**

Since the appearance of Siddiq's pioneering model of Islamic banking, envisaged on the pattern of an interest-free Anglo-Saxon model of commercial banking, several either marginally improved or radically reformed as well as

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<sup>95</sup> Faisal Islamic Bank of Bahrain, which joined the rank of Offshore Banking Unit (OBU), has no lender of last resort facility. While the licensed OBUs are authorized to freely involve themselves in transactions with non-residents, they (i.e., OBUs) are not normally authorized to transact with residents. In the background of the distinction made between accounts held by residents and non-residents, OBUs are not normally authorized to hold resident accounts.

<sup>96</sup> These banks are competing with Saudi commercial banks for deposits and are participating in the investment activity by taking advantage of Foreign Capital Investment Law. These banks are allowed to invest in projects that may not be funded by the Saudi specialized credit institutions.

<sup>97</sup> However, SAMA has indirect influence on an OBU through its money/foreign exchange activities (e.g., Riyal Deposits in OBU are subject to SAMA's control through its power to adjust the legal reserve requirements and the exchange rate adjustments between Riyal and US \$).

innovated models of the Islamic banking have been theoretically contributed as well as translated into reality. The Islamic banking business in case of all the theoretical model of Islamic banking is instituted on the basis of at least a two-tier *muḍārabah* contract such that the first tier of *muḍārabah* is instituted between the Islamic bank and its depositors, and the second tier of *muḍārabah* is instituted between the bank and the parties to whom the bank provides the finance.

All theoretical models of the Islamic banking system, with the exception of models of the Islamic banking system contributed by Al-Jarhi(1981) and Anjum (2004) wherein the Islamic banking is accomplished on the basis of 100% reserve requirement, introduced the fractional reserve system-based Islamic banking either as an Anglo-Saxon type of interest-free commercial banking or as a German/Swiss/Japanese type of interest-free universal banking. All the well-known theoretical models of the Islamic banking system, irrespective of the differences in their institutional structures and operational frameworks, are having explicit built-in linkages with Islamic macroeconomic goals of human development/empowerment in socio-economic and political contexts and the scope as well as the degree of effectiveness of the built-in developmental linkages of various models of Islamic banking systems varies in case of different models of Islamic banking.

Instead of being explicitly premised in the geographically universal jurisdiction of the Islamic state (i.e., The Islamic Caliphate encompassing the whole globe), most of the existing well-known models of the Islamic banking are either premised in indifference to the national and universal aspects of the Islamic banking system or implicitly premised in the narrowest Western nationalistic framework of the ethnically and geographically disintegrated Muslim states. Introduction and implementation of the narrowest nationalism-based models of the Islamic banking, by ignoring the humane universal dimensions of the Islamic banking system, has been very costly for the masses of the individual Muslim states in terms of colossal welfare losses, which have been experienced not only within national economies due to the prevalent domestic stagflationary regimes but also in arenas of international trade and finance, resulting from the weakest monetary position of all national currencies of the individual Muslim states as compared to the strength of the U.S. \$ as a vehicle currency primarily because of lack of the institutional capacity required for exploiting the potential economies of optimal monetary management that are realizable only in universal Islamic monetary framework.

Well-known earlier theoretical models<sup>98</sup> use terms ‘banking without interest’, ‘interest-free bank’, ‘elimination of interest from economy’, ‘interest-free economy’, ‘Banque D’Affaires’, ‘Central Bank’, ‘treasury’ instead of explicitly using more comprehensive Islamic terms such as ‘Islamic banking’, ‘Islamic bank’,

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<sup>98</sup> i.e., Models contributed by Siddiqi (1969), CII (1980), Al-Jarhi (1981), and Chapra (1996).

‘Islamization of the Economy’, ‘Islamic economy’, ‘Banque D’Affaires’ Islamique’, ‘Islamic Central Bank’, and ‘Islamic Treasury’. However, the use of the adjective ‘Islamic’ is inevitable because an interest-free institution or transaction can get qualified as an Islamically allowed institution or transaction only by satisfying many other Islamic prerequisites as well (e.g., A *muḍārabah*-based interest-free business of wine is not at all an Islamic business.).

Siddiqi’s model of the Islamic banking is implicitly premised in a narrow nationalistic framework envisaging the Islamic bank owned by the private shareholders who earn profits especially through the facilities of creation of bank money on the basis of fractional reserve system. It portrays many institutions of the Islamic banking system. But, it illustrates only some of the many progressive dimensions of the overall Islamic banking system because it is portrayed to be instituted by the Islamic state in isolation from the operation of other institutions of the Islamic economic system with the exception that this model presents a highly enlightening and systemic discourse in the context of accomplishing progressive public finance through a cooperative interaction among the Islamic state’s government, its treasury, and the Islamic central/commercial banking system. It fails to envisage Shari‘ah Board as an integral part of Islamic banking.

By advocating a safe method of profitably investing the bank capital in the form of the investment of bank capital accomplished on the basis of principle of active partnership characterized by the limited expansion of the joint business in the sense that large amounts of funds are not invested for very long periods, Siddiqi’s model of Islamic banking does not allow the Islamic bank to act as a perfect development finance institution because its policy design fails to finance the gigantic very long-term development projects<sup>99</sup> which are almost non-existent in most of the contemporary Islamic countries and which inevitably require highly risky investments of large sums for very long periods and for realizing economies of scale in production. Unfortunately, the limited nature of the scope of investment in Siddiqi’s model of the Islamic bank is also practically manifest in the insignificant<sup>100</sup> developmental role played by the overwhelming financing of short-term investment projects primarily accomplished on the basis of the least risky mode of the financing ‘*murābaḥah*’ while the share of highly risky profit-sharing modes in the total financing accomplished by the Islamic banks is very small (Al-

<sup>99</sup> e.g., motorways, large dams etc.

<sup>100</sup> This practically weak aspect of the Islamic commercial banking seems to be a reflection of the modern capitalistic commercial bank’s defective historical record of refraining from investing money in industrial, commercial, and agricultural businesses on the basis of principles of partnership. Perhaps, the historical dynamics of the capitalistic banking have not only dampened the potential developmental role and scope of Siddiqi’s model of Islamic commercial banking in bringing about long-term development-oriented structural transformation in the Islamic economy but also practically inspired Islamic banks to accomplish an extremely low level of long-term development-oriented financing based on *muḍārabah* and *mushārahah*.



Jarhi et. Al., 2001). A critique of this defective practise of the Islamic banks was documented (Ahmed, 1995) by Abdul Rahman Yousri Ahmed.<sup>101</sup>

CII 's theoretical-cum-practical model of Islamic banking, reflecting a full-fledged governmental initiative and a response to the challenges confronted by the Islamic polity in Pakistan, is a multidimensional practical problems-specific Islamic banking model envisaging the progressive coexistence of the development-oriented and mutually supportive Islamic commercial banks and the Islamic specialized financial institutions in Pakistan. It signifies the historic watershed of the voyage of the politico-economic movement of the Islamic banking from the academic corridors into the corridors of power at the national and global level. It became not only instrumental in practically instituting an official process of the Islamization of the entire national economy of Pakistan but also influential in conditioning the movements of the Islamization of banking all over the globe. Above all, it has become a touchstone of the degree of Islamicness of the banking services of the contemporary Islamic banks. Particularly, its recommendation of limiting the usage of the Islamically permitted modes other than profit/loss-sharing and *al-qard al-hasan* to the minimum possible extent has left profoundest impressions in the minds of banking public due to which especially the financing performance of the Islamic banks, which overwhelmingly use *bay' mu'ajjal* as a financing device, has been eclipsed not only in the minds of banking public but also in the sight of certain economists.<sup>102</sup>

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<sup>101</sup> He stated, "1. The actual practices followed by most Islamic banks that have issued securities point to a general trend towards diversification of investments, with a view to reducing their risks. Of course, the policy of diversifying investment and risks under the conditions of a small-size market with limited purchasing power (which is the case in most Islamic countries) in addition to tight organizational facilities, could only lead to the emergence of modest projects in the field of commerce, consumer goods or food processing industries, construction, hotel industry and tourism. These are the traditional and familiar fields in the (developing) Islamic countries which gain the interest of most investors, Muslim and non-Muslim nationals and foreigners, who want to reduce their investment risks and achieve relatively quick returns. It was, therefore, expected under such circumstances that the role played by Islamic securities in terms of bringing about structural changes in the projects' size or field of activity would be limited.

2. Most of the issued securities have a maturity of one year or less (three years in some cases). This does not provide any real opportunity for long-term financing for productive projects, particularly in the industrial field. Hence, most of the issued securities are not expected to be instrumental in effecting structural changes in the economy."

<sup>102</sup> e.g., Ziauddin Ahmad states (Ahmad, 1984), "Too much dependence on Bay Muajjal/Murabahah also means that the change that has taken place is more in the form than in substance." Similarly M. Fahim Khan states (Khan, 1998), "One very simplest view based on the practice of existing Islamic banks can be that we can take mark-up based financial system as an alternative to interest. Islamic economists, however, are critical of this approach on the ground that this will not reflect the true spirit of Islamic economic system and would simply be an instrument to bring interest from back door and hence

## 6. Policy Recommendations

The first and foremost policy recommendation for realizing the zenith of Islamic banking is to officially promote a system of consensus-based Islamic banking which limits itself to the use of only those modes of the Islamic banking and finance which command the consensus of the Islamic economists as well as jurists. In this background, ICBBs are modelled along the lines of Islamic consensus-based banking which accomplishes corporate governance-oriented Islamic universal banking by using only those modes of the Islamic banking and financing (e.g., *mushārah* and *muḍārah*) which command the general consensus among the Islamic jurists and economists and, thereby, the confidence of the global Muslim community. In the Islamic consensus-based banking, the Islamically recognized welfare of the entire world's all stakeholders will be defended and promoted. Because of the non-controversial nature of the Islamic consensus-based banking, the banking and financing services of the ICBBs will become equally popular among the world's all Muslims, including those who otherwise have reservations about the indiscriminate use of modes of financing other than *mushārah* and *Mudrarabah*, thereby leading to the branching out of ICBBs on the grass roots level and to their success as real development-finance institutions.

ICBBs, on their liabilities' side, can institute checkable demand deposits on the basis of 100% reserve requirements and *muḍārah* deposits/*mushārah* deposits/*wakālah* deposits/swift sadaqaat disbursement accounts/firm commitment-based participatory deposits<sup>103</sup> to be made available to an ICBB on its demand within one week or two weeks without any reserve requirements. On their assets' side, ICBBs can provide financing on the basis of 'service-charge-free *qard-i-Hassana*'/*muḍārah*/*mushārah*/share-cropping-based *musāqah* and *muzārah*, finance their own trading and investment activities, finance the establishment as well as the business of their own subsidiary companies, and provide fee-based services (e.g., services of money transfer, bank drafts, letters of credit, share brokerage, traveler's cheques, etc.). On the basis of *muḍārah*/*mushārah*/share-cropping-based *musāqah* and *muzārah*, ICBBs can introduce financing instruments of equity participation, *muḍārah* certificates, *mushārah* certificates, *musāqah* certificates, *muzārah* certificates and *al-qard al-Ḥasan*

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nothing will change in the economy. Islamic economists believe that a true alternative to interest would be the introduction of profit-loss sharing based financial system in the banking system."

<sup>103</sup> Idea of firm commitment-based participatory deposits of ICBBs introduced in this paper is an innovated version of the idea of Mannan regarding the introduction of firm commitment participation certificates (Mannan, 1993) as an Islamic bank's instrument which leads to the efficient employment of the funds such that the bank shall call funds only in case of emergence of its actual needs for financing its investment.

certificates which have already been introduced in Malaysian economy for accomplishing non-inflationary financing.

ICBBs will be extremely decentralized in decision making, which will be accomplished in consultation with all people living in their neighbourhoods/jurisdictions, regarding their financing activities. ICBBs will offer equal opportunity to all their clients on their liabilities' side as well as assets' side to freely negotiate the terms and conditions of their financial contracts especially the profit-sharing ratio with the authorities of ICBBs. ICBBs will institute a humane pattern of banking which is perfectly Islamic, progressive, state of the art (i.e., high-tech/efficient service-oriented), equitable, perfectly see-through/transparent/disclosed, and promoter of individual as well as social welfare through the heart-winning cordial bank-clientele relationship. ICBBs will have high-powered Shari'ah Boards which will be working under IMAN's autonomous Central Shari'ah Board located at the head quarters of IMAN. From the point of view of restoring/developing the confidence of the global Muslim masses in the Islamic consensus-based banking system, Shari'ah Boards will completely avoid the use of Shari'ah tricks. All ICBB's will necessarily be the members of the IMAN .

The rationale for instituting ICBBs arises in the background of the fact of persisting widespread misconceptions/skepticism in the context of resemblance between certain practises of contemporary Islamic banks and the practises of conventional interest-based banks, and the corresponding lack of confidence of the masses ranging from Pakistan to Indonesia in the contemporary Islamic banks' primarily used Shari'ah-tricks-based modes of financing other than *musharakah* and *muqarabah* despite the fact that the contemporary Islamic banks seem to be satisfied with their growth/branching performance and with the Islamic compatibility of their overwhelmingly used modes of financing especially since<sup>104</sup> the publication of Hamoud's critique of principle of profit-sharing which could not satisfy even IDB prize winning Islamic economists like Abdel Rahman Yousri Ahmed. So, it is hypothesized that still there exists an overwhelmingly large segment of Muslim masses which could not be targeted by the Islamic banks and this segment can be easily targeted by scientifically instituting as well as by massively socializing the progressive practise of Islamic consensus-based banking system in the Islamic world. The Islamic consensus-based banking system will not only popularize and reinvigorate the Islamic banking and empower/develop the humanity but also marginalize those Islamic banks which misuse Shari'ah tricks as well as the conventional interest-based banks which are inherently inequitable and inefficient. Inherent inefficiency of the conventional interest-based banks is proved

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<sup>104</sup> i.e., since 1982.

by their history of widespread failures<sup>105</sup> despite the existence of official supporting mechanisms.<sup>106</sup>

Muslim masses' built-in-confidence in ICBBs will be the vehicle asset of the Islamic consensus-based banking system which will globalize and universalize the practise of the Islamic banking as well as lead to the development and empowerment of the Islamic money market as well as the Islamic capital market in the whole world. Europe is already on the way to feel and appreciate the flavour of the glamour, power, and prowess of the Islamic financial system. It is hypothesized that the progressive pan-Islamic monetary regime and its consensus-based banking system will culminate into the zenith of the movement of the Islamic banking and finance. For achieving the long-term developmental goals, application of 'increasing *mushārah*' is being recommended along with the recommendation for the practise of the following principles:

- principle of transparency through appropriate disclosure mechanism
- principle of socializing Islamic banks and their products through regular social interactions among all stakeholders of the Islamic banking system for overcoming their problem of the scarcity of their social capital for ensuring the branching out of the Islamic banks on a massive scale
- principle of observing merit in allocation of the financial resources
- principle of realizing Islamic synergy through cooperation among the Islamic banks
- principle of individualized banking accomplished by negotiating profit-sharing ratio with each and every customer of the bank
- principle of decentralized decision making in the branches of the Islamic banks for the efficient allocation of financial resources through communitarian banking.

It is also recommended that introductory contents about Islamic economics and Islamic banking should be included in the subject of Islamic studies taught in high schools for creating deep-rooted awareness of the nature, significance and practise of Islamic banking. Finally, a permanent forum of Islamic economists, bankers and jurists must be set up for filtering the best Islamic consensus-based products and services of ICBBs.

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<sup>105</sup> Failure of 2573 banking/financial institutions in the form of commercial banks and Savings & Loans (S&Ls) occurred in the U.S.A. in the period 1982-1994 (Thomas, 1997).

<sup>106</sup> e.g., Federal Deposit Insurance Corporation instituted on the basis of the Banking Act of 1933 in the U.S.

## 7. Conclusion

Our latest extensive inquiry into the contemporary movement of the Islamic banking manifests the humane, social, dynamic, innovative, progressive, equitable and universal character of the fast evolving Islamic banking system on the global level due to its natural conceptual appeal which cuts across all regions, cultures, religions and economic systems. The panorama of crystallization of several distinct multi-faceted theoretical and applied models of the Islamic banking system as the variants of the originally published two-tier *muḍārabah* model of the Islamic commercial banking is a spectacular result of the continuous feedback/feedforward between theory and practise of the Islamic banking system which have been enriching the literature on the subject. Despite the spectacular pioneering achievements of the contemporary movement of Islamic banking, there exists a lot of the unexploited potential in the arena of the Islamic banking on the global level which can be exploited by realizing an autonomous pan-Islamic monetary regime-based synergy among at least several prospective constituents<sup>107</sup> of the Muslim *Ummah*.

In the background of the coexistence of certain Islamic consensus-based modes of Islamic banking/finance and certain consensus-lacking modes of banking/finance used in the contemporary Islamic banking system, which is one of the factors due to which the contemporary Islamic banks have not been completely successful in developing their clientele in a wider circle of Muslim masses, a permanent globally representative authoritative board of the Islamic jurists/economists and bankers merits to be set up for developing consensus on certain Islamic principles/modes/instruments/products/services from the point of view of instituting and promoting an ever-popular regime of the Islamic consensus-based banking system which can lead to standardization of the Islamic banking procedures/services/products, generate as well as exploit social capital, command the confidence of the global masses, and, thus, provide the financial fuel to numerous engines of growth and human development in the universal framework of the Islamic economy.

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<sup>107</sup> e.g., Islamic states and their residents as well as Islamic minorities living in non-Islamic states, the IDB, Islamic banks/financial institutions, Islamic Treasury and Baytul Mal, Islamic money market, Islamic capital market, Islamic universal common market, Islamic jurists/economists/bankers/banking public, media, and all other stakeholders of the global society.

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