SHARI'AH PERSPECTIVE OF MONEY CREATION IN ISLAMIC BANKING: A PORPOSAL FOR AN ALTERNATIVE MODEL

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ABSTRACT

Islamic banking provides banking products and services based on *Shari'ah* rules and principles. The critical role played by Islamic banking has been discussed because of the gradual expansion and growth of this sector. The resilience of Islamic banking during the global financial crisis in 2007 also attracted considerable attention to the role it can play in the global economy. Islamic banking has significant economic and social influence, particularly in Muslim societies seeking *Shari'ah* based banking activities. Therefore, this study investigates the position of Islamic banking towards the issue of money creation and discusses it from *Maqasid al-Shari'ah, Akhlaq* and *Fiqh* viewpoints. These noble objectives are achieved through the analysis of library sources and by developing a viable model for Islamic banking to overcome the issue of money creation, especially in Islamic banking. With a view to meet this objective, a qualitative semi-structured interview method is adopted. The findings of this study demonstrate that Islamic banks create money due to the adoption of the conventional banking system that is based on the fractional reserve system. This goes against the main objectives of the *Shari'ah* such as preservation of people's wealth since this created money would decrease the value of people's wealth due to inflation and encourage banking default and financial crisis. Due to these negative impacts of money creation in Islamic banking, from an *Akhlaq* viewpoint, it is contrary to the *Shari'ah* that seeks to ensure the justice of wealth distribution and not to burden people with additional debt. Similarly, *Fiqh* views the money creation in Islamic banking as unlawful due to evidence from the Quran, Sunnah and *Shari'ah* scholars. One evidence is that gaining profit from money creation promotes fraudulence and deceit prohibited by Allah "Woe to the fraudulent" (*Al-Mutaffeen* 83: 1). Consequently, this study develops a viable model that prevents Islamic banking from creating money and its implications. It differs from current and saving accounts whereby the current account must be 100% fractional reserve to prevent banks from creating money. The saving account will become similar to an investment account that Islamic banks can use for financing and expansion in the form of partnership or agency concepts. Due to the nature of investment account, the deposit would not be guaranteed, meaning that there is no need for fractional reserve. Therefore, the Islamic banking will not be able to create money, and the return from the depositors' money is shared between the Islamic bank and the depositors. These findings are expected to contribute significantly to Islamic banking.

ملخص البحث

المصرفية الإسلامية أسست لتقدم منتجات وخدمات بناء على تعاليم الشريعة الإسلامية. وأصبح لهذه المصرفية دور مهم في المجتمعات المسلمة خاصة، وذلك بسبب نموها المستمر. مع ذلك لا زال هناك بعض الإشكالات التي تحتاج للبحث كمسألة توليد النقود. لهذا أتت هذه الدراسة لتبحث دور عملية توليد النقود في المصارف الإسلامية، وموقف الشريعة منها، بالنظر إلى معايير المقاصد والأخلاق الشرعية والفقه، بالإضافة إلى تطوير نموذج للمصارف الإسلامية يتجاوز من خلاله إشكالية توليد النقود. وهذه الأهداف المهمة من البحث سيتم التوصل إليها باستخدام التحليل للنصوص الشرعية، والنظر للمصادر العلمية خاصة الشرعية منها كالكتب والأبحاث. وكذلك فقد تم استخدام أداة المقابلة مع الخبراء شبه المنظم لتقويم ودعم الوصول لأهداف البحث. وقد تم التوصل إلى بعض النتائج المهمة في هذه الدراسة ومنها: أن المصارف الإسلامية تقوم بعملية توليد النقد بسبب اتباعها للنظام البنكي التقليدي، والذي يعمل على أداة الاحتياط الجزئي الداعية إلى توليد النقد في المصارف. وبالنظر إلى حكم توليد النقود في المصارف الإسلامية فقد تبين أنها مخالفة للشريعة، وذلك لمعارضتها مبادئ وأهداف الشريعة ومقتضى الأخلاق الشرعية المتمثلة بحفظ أموال الناس، وعدم أكل أموال الناس بغير حق، والذي يتمثل بتقليل قيمة النقد والثروة التي بأيدي الناس بسبب زيادة النقد والتضخم والوقوع في الأزمات الاقتصادية. بناء على هذا، فقد قامت هذه الدراسة بتطوير نموذج قابل للتطبيق يتفادى إشكالية عملية توليد النقد خاصة في المصارف الإسلامية. ومن أهم معالمه، أنه يفرق بين الحسابات الجارية والادخارية. فالحساب الجاري يكون خاضعا ل 100% في الاحتياطي الجزئي لمنع المصرف من توليد النقد من خلال هذا الحساب، فلا يتعلق بهذا المال أكثر من ذمة. وأما الحساب الادخاري فيكون حسابا استثماريا عن طريق عقود المشاركة، أو الوكالة بين المودع والمصرف، وبهذا لا يكون هناك حاجة لإخضاعه لنظام الاحتياطي الجزئي حيث أنه غير مضمون من قبل المصرف. وبهذا يكون المصرف غير قادر على توليد النقد، وبالوقت نفسه يحافظ على دوره في العملية الاقتصادية بالتنمية بالاستفادة من الحسابات الادخارية الاستثمارية. وفي المقابل يكون المودع قد حصل على عائد من خلال استثمار أمواله بالتعاون مع المصرف مما يحقق في النهاية الفائدة للجميع، بارتباط النمو بالاقتصاد الحقيقي. لهذا فمن المتوقع أن يكون لهذه النتائج اسهام كبير في تطوير المصارف الإسلامية وتقويتها.

APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigation, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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To my great father

Ibrahim Ali Altwijry

May Allah grant him Al-Firdus Al-A'la

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قال تعالى: "إِنْ أُرِيدُ إِلَّا الْإِصْلَاحَ مَا اسْتَطَعْتُ ۚ وَمَا تَوْفِيقِي إِلَّا بِاللَّهِ ۚ عَلَيْهِ تَوَكَّلْتُ وَإِلَيْهِ أُنِيبُ"

"I only desire reform so far as I am able, to the best of my power. And my guidance cannot come except from Allah, in Him I trust and unto Him I repent" (Surah Hud 11: 88)

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The banking industry has become very significant to modern economies to the extent that governments, firms, and individuals cannot afford to do without it. For governments, banking plays an important role to facilitate their transactions and operations. It decreases most of the payment costs faced by governments such as collecting tax payments, operations, and services cost. Governments save collection costs by banks shouldering this responsibility sometimes without charge. Moreover, the banking sector helps governments save their money and perform financial transactions. For instance, governments can face credit shortages for which they then refer to banks to assist in financing. Also, as banks are part of the economic cycle and are experienced and professionally managed entities, governments need banking to supervise and regulate their economies.

Regarding companies, the banking industry operates closely with companies as firm dynamism is often a measure of the amount of money it possesses. It is tough for firms to grow and expand without banking products and services. Nowadays, most companies increase their capital and expand businesses via banking channels. Banks facilitate trade transactions between companies. For example, banks act as the trustee for companies as well as easing international trade by issuing banking drafts and transferring money. An important task of banks is to collect and receive payments. Customers transfer most of the payments to the companies’ account, which facilitates trade and minimises risks associated with the physical transfer of money. As such, banking is a significant partner in business and transactions.

Another important area where banking is influential is the individual's dependency on banks for most of their financial transactions. Individuals save their money with banks for security and convenience. Moreover, most people receive their salaries from governments and companies through banks. This is a necessary security concern as unsafe external environments could put people and their money at risk. Furthermore, the banking sector helps many people by offering products and services that solve their financial problems. Banks offer loans for marriage, purchase of vehicles and houses, among others, which are necessary for most individuals. For example, houses are a necessity but expensive. Thus, people need banks to meet their basic needs. Banks make financial transactions easy. All that is required is an electronic card or mobile app, which are provided by banks to perform their daily financial transactions. In short, to individuals, the banking sector is a necessary and important part of their life.

Rapid technological changes have allowed the banking sector to improve their products and services. In the past, banks provide their services and products only at their physical branches. Nowadays, most banking products and services are online. Among these services and products are ATMs, online banking, phone banking, credit, debit and prepaid cards, and shopping payment points. The banking sector is the most professional and well-managed sector with the latest technology, security, smooth procedures, and strict and transparent rules and regulations.

The banking industry has expanded to include Islamic banking, which is gradually becoming mainstream in Islamic countries. Islamic banking offers interest-free banking. It's services and products have expanded and increased to include most of the products and services that are provided by conventional banks. The common three levels of these banking products and services are retail, commercial [corporate], and treasury. It serves individuals with interest-free products such as personal and home financing. These products can be conducted under *murabahah* (mark up sale) and *ijarah* (leasing) financing contracts. Meanwhile, there is Islamic commercial banking which concentrates on serving and offering products to governments and firms based on *Shari'ah* rules. Examples of products from this banking level include working capital and letter of credit. Moreover, as there are many products and services in capital and money markets that are complaint with *Shari'ah*, Islamic treasury banking effectively participates in this sector. Islamic banking treasury products include the issuance and structuring of *sukuk* and equity stocks. Furthermore, the capital and money market sector is growing rapidly and attracting more customers and businesses due to its unique rules and regulations that rely on *Shari'ah* principles and values.

Despite the significant role that the banking industry has played over the years, its reliance on the fractional reserve system is heavily criticised. The fractional reserve system is a law whereby banks are required to place a certain percentage of their customers' deposit with the central bank to increase the trust level among depositors. While the remaining fraction of the deposits in the debit side of a bank's balance sheet is the amount of money allowed for banks to lend. This is theprevalent system that governs today's monetary system (Meera & Larbani, 2009). This system has been identified as the cause of many problems, notably banking failure, increasing of money supply and debt level, unfair wealth distribution, and creating money out of nothing. These are some of the main issues created by the fractional reserve system that have negative influences not only on economic and financial sectors, but on social, political, and religious aspects as well.

According to Soh (2004), the fractional reserve system is one of the causes of banking failure. To illustrate, as this system saves some of the money from deposits, some part of the deposit will be risk-free which encourages risk-averse individuals to deposit their money with banks. Banks take this advantage to invest in more risky businesses. This risk is transferred to the bank's capital holders leading to asymmetric information. Moreover, deposit insurance that is given by some of the central banks to cover the risk of this system minimises the depositors' incentive to monitor the risks taken by banks. Deposit insurance and asymmetric information are causes of moral hazard and sources of banking failure that put the depositors' welfare at risk. Hence, banks would invest in higher risk businesses and lend money to higher probability customers, eventually leading to moral hazard. When banks are involved in highly risky deals and transactions, the bank's managers hide information from the depositors. This is considered asymmetric information and will result in the banking sector facing the critical issue of depositors losing confidence in the banking industry thereby exposing banks to failure.

Another problem caused by the fractional reserve system is increasing the money supply and debt eventually leading to hyperinflation (Landis, 2004). As this system allows banks to lend the fraction of reserve requirements, financing becomes its main business and most profitable channel. This is because it is less risky as loans are attached with collateral in case of default and is an act of simply circling the depositors' money with interest. As such, banks would compete to lend more to customers toearn high profits by reducing the interest rate to increase the money supply in the economic circle. Hence, money can be easily obtained, which leads to an increase in the prices of goods and services. However, these fundsarea type of debt that must be repaid to the lender, which is often the bank that lends depositors' money via the fractional reserve system. The increasing debt volume caused by this system would consequently lead to financial defaults and crisis as well as social and economic instability (Fisher, 1936; Rothbard, 1995). The issue of money creation indeed influences these economic issues. When banks have the ability to create money, this created money will increase the money supply in the market since it is legally adopted and used by the market players. Moreover, money can be created by banks through financial and loan instruments; hence debt levels would increase as banks will lend more to create more money. As such, with money creation, the banking sector would increase the degree of money supply and debt, which have negative impacts on the economic cycle.

Income disparity is another problem of the fractional reserve system. When the banking sector is given the green light to increase the debt burden on borrowers either individuals, firms, or even governments, this sectorwill control money channels and distribution of wealth. As lenders, banks lend depositors' money with interest that does not yet exist in the form of money, but it is an addition that has to be paid to the lender on top of the principle amount. This nearly guarantees default by borrowers (Meera A., 2009). When this occurs, banks absorb the collateral. As a result, people's wealth will end up in the hands of bankers, who are few, while the majority suffer. Norm Franz (2002) states that debt is the money of slaves because lenders control debtors causing social instability since wealth is not fairly distributed. Another symptom of the fractional reserve system is unjust wealth distribution. This symptom is manifest when the authority gives some market tools to certain people while others are not allowed to adopt them. One of these tools is creating money. By law, banks have the right to create money and own it via the existing banking system. Individuals are banned from any deposit except through commercial banks. At the same time, individuals are only allowed to borrow from banks and similar institutions. Thus, bankers would have more money, which others are prevented from. In the end, money and wealth will not be fairly distributed, but concentrated in the hands of the few.

Creating money out of thin air is another problem of the fractional reserve system. Based on the structure of this scheme, banks cancreate money via cycling money among banks. In other words, determination of the aggregate volume of bank deposits is a matter of accounting and arithmetic by simply dividing the available supply of bank reserve by the required reserve ratio (Tobin, 1964). This allows the banking industry to own and claim money that does not exist and is created by them via this system. This created money would be legally used in the markets and consequently accepted as an exchange of goods and services. As a result, those that create such money would enjoy free goods and services as permitted by this system (Meera A. K., 2004). This created money would eventually increase the money supply and lead to inflation as well as injustice in wealth distribution among others (Fisher, 1936; Paul, 2009; Leithner, 2011; Vadillo, 1996).

Since the banking sector is permitted to create money out of nothing, it would increase the volume of debtors that includes high-risk debtors, to expand its profits and enjoy the benefit of created money. Banks will enjoy the benefit of creating money since it would be the first owner that enjoys free legal money.

The issues related to the fractional reserve system and its negative influences have compelled many researchers to suggest solutions. One suggested solution is 100% fractional reserve. This means that all the depositors' money is kept in reserve. This suggestion will minimise the risk connected with banking runs (Dittmer, 2014). It also overcomes some of the financial risks such as asymmetric information and financial contagion that face the banking sector. Since banks will keep all the deposited money as a reserve, they do not need a lender of last resort (Hülsmann, 1998). Hundred percent reserve banking assures a stable money supply. It improves the efficiency of the price mechanism, promotes savings, provides greater confidence in the financial system and the integrity of all commercial transactions and therefore encourages sustainable, non-speculative, productive investment (Hülsmann, 1996; Rothbard, 2008). Most importantly, with 100% reserve, banks will not have the ability to create new money. Therefore, the issue of creating money out of banking transactions would be eliminated.

This solution is criticised for not being applicable and radical to the current development of financial and economic sectors (Cagan, 1986). When the fractional reserve is 100%, banks will not have the ability to lend and finance compared to the other existing paradigm. Hence, money circulation will not be fast (Litan, 1987). Moreover, full reserve might cause an increase in the interest rate as banks will be able to lend only the capital, which will sharply limit the finance due to the limited available money. Hence the cost of finance would be higher (Litan, 1987; Soh, 2004). Therefore, there seems to be a need for a viable alternative solution.

The second suggested solution for money creation is that the banking industry should be owned by the public sector, called the nationalisation of banks (Robertson, 2000). Nationalised banks will belong to all members of the society. Instead of the public suffering from the effects of money creation, they could benefit from it. As a result, nationalisation of banks would be a possible solution to this issue.

Some argue that this is not going to solve the issue. They claim that nationalisation will not prevent banks from creating money. Furthermore, all the adverse impacts of money creation will remain although at a minimum level. Moreover, making banks public might revert the efficient and transparent distribution of banking to the public, which could be abused. In most countries, particularly developing and undeveloped countries, resources and wealth are unfairly distributed (Mehta, 2000; Singh, 2012). The best example of the inapplicability of this solution is that in most countries, nationalised companies do not return the benefits to public (Singh, 2012). Furthermore, if the nation owns banks, they would continue to create the same problems since they continue to operate under the same system. Therefore, the negative aspects of this system such as inflation and increase of money supply will influence the society, the poor and rich alike. This isunfair as this hidden tax will be paid by all including the poor (Meera & Larbani, 2009). Hence, public banking could be unsuitable to solve the issue of money creation. Similar to the suggestion for full banking reserve, the solution of nationalisation of banks does not look promising as a viable alternative.

Another recommended solution is imposing a tax on money as public revenue to collect the value of newly created money. There are two reasons for this suggestion. The first is that commercial banks mostly operate in a highly competitive environment. This competitive environment would eventually lead to higher profits that would benefit the public. Secondly, the effects of money creation would be distributed fairly and efficiently. Money that is created by banks would return to the public. Thus, imposing the tax would benefit the public from the value of newly created money (Robertson, 2000).

This suggestedsolutionwas also criticised for imposing tax the will not prevent banks from creating money out of the deposited money. Additionally, the tax would be a certain percentage of money that is created. Thus the remainder would go to the owners of banks, which does not solve the issue. Furthermore, nowadays banks pay the tax to the government, which includes the profit from the created money. Similar to the above-suggested solutions, imposing a tax on banks does not appear as a practical alternative.

Despite the suggested solutions to overcome the issue of fractional reserve and money creation, fractional reserve banking system is still in operation possibly due to the inapplicability of these suggested solutions in addition to the support the existing system receives from powerful countries (Alsabhani, 1998). Nevertheless, these justifications do not mean the system is correct. There is a need to remove the negative elements to ensure a fair and just banking and financial system.

Would Islamic banking be able to give a solution to this issue? According to Bank Bangladesh's report (1999), in theory, the original spirit and role of Islamic banking seem to be against freely earned money and gaining profit without productive efforts that are normally obtained throughout the fractional reserve system. Therefore, Islamic banking is expected to be different from the existing conventional banking system. In practice, however, Islamic banking is found to adopt the conventional banking. Hence, as Islamic banking operates under the same system, what would be the *Shari'ah* view on this matter.

Shari'ah scholars or *fuqha*differ on this issue with some allowing commercial banks to create money, while others do not (Alsabhani, 1998). It is worthy to mention that some of those who allow banks to create money from deposits include conditions such as banks must be solely owned by governments (Ahmed Ali, 1983; Ubadah, 2011). The condition that gives government-ownedcommercial banks the ability to create money eliminates some of the adverse effects of this issue because governments mostly work for the public interest, unlike people who look for self-interest only. On the other hand, some Muslim economists allow commercial banks to create money and consider it permissible in the *Shari'ah* (Mitualli & Shahtah, 1983; Chapra M. O., 1985; Afar, 1994; Nyazee, 2000). Some introduce conditions like private banks should be supervised and monitored by the government and some of the return from the money created should be channelled to the government.

In contrast, some Muslim economists opine that banks do not have the right to create money due to the absolute negative influence on different aspects of peoples' lives (Alsabhani, 1998; Meera A., 2009; Larbani & Meftah, 2013). Although there is an absence of in-depth discussion on the issue of money creation in Islamic banking, there is also a lack of viable model to overcome this problem, particularly for Islamic banking. Despite caution from researchers about the serious challenges facing the banking sector, Islamic banking continues to adopt this conventional fractional reserve system that is responsible for money creation.

1.2 PROBLEM STATEMENT

Islamic banks have progressed rapidly globally. However, it is still operating on a conventional structure based on money creation. Studies show that money creation results in inflation, unemployment, and financial instability, which create social and economic injustices and instability (Fisher, 1936; Friedman, 1960). Economists and researchers have recommended solutions to the issue of money creation by suggesting changes to the fractional reserve system. Nevertheless, this system is still prevalent, and its negative consequences and impacts still affect people's lives.

Islamic banking seeks to provide banking products and services based on Islamic principles, theories and objectives. However, after over 40 years of operation, Islamic banking is still operating on the conventional platform and thus adopting the same fractional reserve banking system. This system is heavily criticised not only by Muslims but also by non-Muslim economists (Hülsmann, 1996; Hülsmann, 1998;

Nyazee, 2000; Meera A. K., 2004; Hassan, 2007; Rothbard, 2008; Paul, 2009; Dittmer, 2014). The fractional reserve banking system has negative impacts such as inflation, unjust wealth distribution as well as high unemployment and crime rates (Fisher, 1936; Friedman, 1960; Meera, 2004). In short, this system that Islamic banks continue to follow leads banks to create money, which goes against the *maqasidal-Shari'ah* (Meera A., 2009; Larbani & Meftah, 2013).

The literature on the subject has focused on the contractual aspects and *fatwas* on *riba, gharar,* and *maiser* in Islamic banking operations. Unfortunately, there is little interest from scholars on issues relating to the fundamentals of the Islamic banking system particularly the fractional reserve system and money creation. Hence, there is a serious need to discuss these issues from the *Shari'ah* perspective and investigate the extent to which Islamic banks remain fully *Shari'ah* complaint if they adopt the fractional reserve system and create money. There is hardly any Islamic consensus on money creation. Furthermore, the literature has thus far failed to provide an alternative model for Islamic banking to overcome the problem. Thus, there is a critical need to develop this alternative model.

The present study fills this research gap by investigating the issues of fractional reserve banking system and money creation from the *Shari'ah* perspective. The study also tries to develop a viable alternative model for Islamic banking to address the problems being created by the fractional reserve banking system.

1.3 RESEARCH QUESTIONS

Given the above discussion, this research hopes to answer the following research questions: