An Inquiry into Alternative Models of Islamic Banking

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Abstract

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 models of Islamic banking have been conceived. 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. Against this background, this research paper synthesizes the published seminal theoretical literature on the subject.

1. Introduction

This paper illustrates the panorama of evolution of the theoretical systemic[2] models of Islamic banking in their chronological order. It 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.

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2 Systemic models of the Islamic banking comprehensively portray the overall institutional structure (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.

2. The Rationale for Instituting the Universal

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. Islamic economists and statesmen[3] have been highlighting the rationale and scope of instituting a comprehensive Islamic system[4] 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, They acknowledge 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.

Keeping in view the prospective usefulness of the Islamic interest-free system of banking/financial intermediation, Islamic economists have been highlighting the rationale of instituting progressive universal monetary regime of autonomous Islamic central banking for realizing the Islamic goal of human empowerment/development.

3. Evolution of the Theoretical Models of Islamic Banking

The following inquiry into ten alternative models of Islamic banking focuses on the task of identifying their nature, salient structural/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,

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3 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.

4 That is, 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.

renders an understandable outline and exhibition of the model of an interest-free Islamic commercial-cum-central banking operating 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 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. He conceives the establishment of an Islamic bank on the basis of al-shirkatul al-in[an which refers to the agreement of partnership between either two or among more than two persons to work[5] jointly in an enterprise with their fixed capital contributions,[6] with their agreed upon proportionate share in the profit,[7] and with their share in the losses strictly in proportion to their respective capital contributions in the partnership-based funds.

For the operation and expansion of business of the bank, it is binding on every partner to authorize the bank to hire the staff (administrative/executive/clerical staff), hire or purchase other requisites (buildings, vehicles, and fuel), to acquire additional capital either on the basis of interest-free credit or on the basis of mudarabah and to offer interest-free loans as well as monetary investments to the needy individuals and institutions. In 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, 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 partners, the power of making decisions is delegated to a Council of Representatives.

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5 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.

6 For example, 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.

7 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.

The business of the bank includes services rendered in exchange for fee/commission/ fixed charges, investment of capital according to principles of the partnership (musharakah) as well as mudarabah, and the free services. The interest-free charged services[8] are an important source of the bank's profit. 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 mudarabah[9] or shirkatul al-in[an.[10] In case of completion of the business, the bank may get refunded its increased or decreased capital according to the profit or loss. For the accomplishment of 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 mudarabah for accomplishing investment as well as the capital procured on the basis of musharakah for accomplishing investment. Banks may also invest a part of their capital in a certain company's common stock shares. They may sell the purchased shares in times of necessity especially for maintaining an adequate level of liquidity.

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8 For example, 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 (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.

9 In case of *mu*da*rabah*-based investment, the bank is entitled to receive a fixed ratio of the profit, which is mutually agreed upon with *mu*da*rib* 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 *mu*da*rib*. If *mu*da*rabah* 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.

10 In case of *shirkatul al-in*[*an*-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.

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 mudarabah account and in a 'loan account'. The bank should keep a small proportion (For example, 3% or 5%) of the mudarabah 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 mudarabah 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 mudarabah 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 and transfer their money to other account holders. As long as money remains in the loan account, bank can freely invest it profitably.

Bank is required to reciprocate the receipt of loans without interest by issuing loans to business parties without receiving interest/remuneration for this service. Short-term loans may be advanced against the production of a security by the borrower.

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[11] 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 to be determined and enforced by the central bank. While assuming that an Islamic commercial bank keeps a fraction (10%) of the demand deposits as well as mudarabah deposits reserved as cash, Siddiqi acknowledges the role[12] of banks in creation and reduction of the bank money.

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 cost of the management of the central bank may be financed from the profits resulting from the sale of Government mudarabah Shares as well as Government Partnership

11 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.

12 Its numerical illustration has also been rendered by Siddiqi (1969).

Shares. 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 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. Siddiqi also recommends that the banks can temporarily[13] borrow from the central bank sums amounting to certain percentage (25%), called 'borrowing ratio[14]', 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[15] for advancing loans against the bills of trade. 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. While recommending only the exceptional use of the inherently inflationary facility of creation of new money for the deficit financing in case of natural calamity or war, he acknowledges that it is inevitable for the Islamic state to procure some part of the people's savings on the basis of mudarabah and partnership (that is, by issuing Government mudarabah Shares[16] and Government Partnership Shares[17]) as well as on

13 That is, for one week or two weeks or three weeks.

14 Borrowing ratio is defined as the proportion between loans obtainable from the central bank and the loans advanced by the commercial banks.

15 For example, 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.

16 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.

17 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.

the basis of interest-free Government Loans by issuing Government Loan Certificates[18] for financing its human development schemes.

In the interest-free banking system, the commercial banks will be keeping Government Partnership Shares as secondary reserves – a source of income for the bank and as a means of liquidity – as well as numerous Government Loan Certificates of various terms in their custody in order to maintain their liquidity. From the point of view of small savers, Government mudarabah Shares will be a suitable alternative to the mudarabah accounts of the banks. These 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.

Report of the Council of Islamic Ideology (CII) recommends the approach of simultaneously remodelling the commercial banking system according to the 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). CII recommends the transformation of the operating procedures of commercial banks envisaged to be instituted on the basis of a two-tier mudarabah without requiring any change in the institutional structure of the commercial banks as well as the operating procedures of specialized finance institutions[19] based on the Islamic concepts of mudarabah and musharakah. 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[20] 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 the fixed investment financing, CII has allowed the commercial banks to provide

18 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.

19 For example, 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.

20 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.

financing on profit/loss sharing basis to those parties[21] which maintain the accounts audited by Chartered Accountants, to provide financing on the basis of arrangements of 'hire-purchase'/bay[mu'ajjal (mark-up)/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/time multiple counter loans to the small parties[22] 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.

Despite developing an understanding about the permissibility of bay[mu'ajjal under Shari[ah and about its applicability only to the unavoidable cases, 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.

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.

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. CII permits the commercial banks to provide services regarding the bills of exchange in exchange for an advance payment of commission which varies in

21 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.

22 Banks finance their working capital needs on the bases of either 'normal rate of return' or *bay*[*mu'ajjal*.

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 under the already mentioned[23] 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 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.

CII's 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[24] 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[25]-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 monetary instruments (State Bank's financial assistance[26] to the commercial banks and other financial institutions as well as the open market operations[27]) with substantial legal-cum-procedural reforms as well as retains most of the conventional monetary policy instruments (for example, minimum cash requirements,

23 That is, arrangements mentioned for financing the working capital needs of the industry.

24 That is, the Islamic Republic of Pakistan.

25 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.

26 For example, 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.

27 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.

liquidity ratio requirements[28] as the statutory obligation of every scheduled bank, overall ceilings[29] on the lending and investment operations of the banks, monetary targets[30] for providing finance to priority sectors, selective credit controls[31], issuance of directions[32], 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 Islamic monetary policy in achieving stability in the value of money. For eliminating interest from the international transactions, it proposes the establishment of Islamic Countries' Trading Block (ICTB) and the promotion of interest-free intra-ICBT trade/aid.

Al-Jarhi (1981) presents 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,[33] and

28 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.

29 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.

30 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.

31 For example, 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.

32 For example, 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.

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

Islamic financial markets culminate in the Islamic financial market equilibrium and economic development. Al-Jarhi's Islamic narrow banking model (core banking model[34]), 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 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, the Islamic central bank has the official authority to create fiat money while anchoring the growth of money supply to the growth rate of economy. Al-Jarhi recommends non-inflationary monetary expansion, which ensures 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. Keeping in view the sufficient flexibility of the role and structure of the Islamic treasury, in the context of expanding its development-oriented activities through taxation and zakah, he rules out any justification for monetary expansion-based financing of the government deficits.

Al-Jarhi proposes the realization of the changes in money supply 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. Against

34 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 ad 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.

this background, the rate of return "ρ" on CDCs denotes an average rate of profit on investment for the whole economy.

Al-Jarhi characterizes a member Islamic bank as a business bank, which gets involved in lending activities, undertakes direct investment as a part of its investment activities[35] and provides regular banking services[36]. 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 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 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 become intertwined.

Ansari (1983) portrays the institutional structure and working mechanism of Islamic banking 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,

35 The set of investment activities of the business bank includes direct investment, which refers to the bank's investment in the form of holding shares in the enterprises as well as participating in the their administration, investment in the short-term profit-sharing ventures and investment in leasing activities..

36 For example, 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 Islamic bank's correspondence relationships with the foreign banks.

community government working under the sacred community leadership symbolized by Imam,[37] regional government, Islamic state, planning organization, mosque, inheritance, zakah/[ushr/sadaqaat, taxation, domestic/foreign trade, education and vocational training, Mutual Saving and Investment Association (MS&I), and Central Monetary Authority (CMA). Families are classified as contractual,[38] non-contractual,[39] and deficit families.[40]

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 prioritized by the community government. A board of trustees appointed by the community leader has the authority of managing 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 musharakah/mudarabah-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

37 The role of Imam, who is the community leader, transcends the mosque and the government, and includes his role in productive investment activities.

38 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 (savings) are generated by all non-marginal families whose positive propensity to save ranges from zero to a medium value.

39 Self-employed families (for example, owner-cultivator peasants, practicing physicians, owners of plants and factories, taxi owner-operators), 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.

40 Deficit families (for example, underemployed, 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.

credit creation exclusively for the community gain and the CMA to regulate[41] 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 mudarabah 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 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 mudarabah 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[42] (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

41 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.

42 SCs are allowed to be used by MS&Is as collateral for getting temporary loans from CMA.

and equitable and, at the same time, brings the rationalized money demand[43] into an equilibrium with the non-inflationary money supply. He argues that the most practical approach of bringing aggregate money 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 (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 jointly by the government and the Islamic commercial banks, which can relieve these banks of the need to demand the collateral from the needy owners of the small businesses.[44] 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 mudarabah 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 and the ability of resisting the dictates and demands of the government for providing loans which are incompatible with the imperatives of price stability. Keeping

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43 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 (for example, *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 π 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.

44 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.

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. Chapra recommended monetary policy instruments such as the statutory reserve requirement only for demand deposits, credit ceilings, government deposits,[45] common pool[46] 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 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:

All financial flows either correspond to real flows or have a check on them due to the partnership-based structure of financing.

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.

Against this background, the foundations of the modern Islamic banking operations are defined in terms of trade (bay[mu'ajjal and bay[salam)-based arrangements, leasing (operating lease)-based arrangements, partnership(i.e., musharakah and mudarabah)-based arrangements, and interest-free lending arrangements based on the collateral (rehn) and guarantees. In this model, Islamic banks are not expected to opt for pure lending. This model asserts that the options of amanah (safe-keeping), wadi[ah (safe-

45 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.

46 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.

keeping combined with the option of benefiting from the asset kept for safe-keeping), loan with service charge, charity and infaq (spending for the sake of Allah), bay[Eeenah (buy-back arrangements), ijarah wa iqtina' (hire-purchase), and time-multiple counter loans[47] 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 amanah and wadi[ah is declared to be uncalled for. In addition, it proposes to institute more than one line of mudarabah deposits as well as perpetual mudarabah 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 mudarabah 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 (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, 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[48] 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[49] budgetary deficits, IIIE's model of the Islamic banking proposes the activation of the institution of Waqf as well as the

47 Time multiple counter loans are not recommended because the ensuing credit expansion is expected to fuel inflation.

48 For example, fulfillment of guaranteed minimum needs of the poor, defense procurement, debt servicing.

49 In this context, a detailed discourse on the subject of the Islamic reforms and related issues is documented (*IIIE*, 1999).

introduction of divisible as well as tradable trade-related instruments,[50] leasing-based instruments including Asset ijarah Securities[51] and Transferable ijarah Warrants,[52] and the partnership-based instruments[53] 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 Shari[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 riba pressures in the arena of settlement of international payments, IIIE's model of Islamic banking system proposes the adoption of IMF[54] 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 introduction as well as operation of control[55] measures as well as regulatory[56] measures for accomplishing central banking and monetary management.

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50 For example, *Bay*[*Mu'ajjal*-Based Tradable Securities, *Istisna*[-Cum-Staggered Payment Arrangement, *Salam* Securities.

51 For example, Simple Asset *Ijarah* Securities, Asset *Ijarah* Securities involving a financial intermediary, and Asset *Ijarah* Securities, issued by the government itself, for a third party acquiring an asset and leasing the same to the government

52 For example, Transferable *Ijarah* Warrants with a finance-lease-transfer arrangement, Transferable *Ijarah* Warrants with a build-lease-transfer arrangement.

53 For example, General *Musharakah* Certificates, Decreasing-Participation/Redeemable *Musharakah* Certificates, Special *Musharakah* Certificates against Existing Pubic Sector Undertakings.

54 IMF signifies the International Monetary Fund.

55 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 *mudarabah* deposits as well as flexible *musharakah* 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.

56 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. IIIE'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.

Al-Jarhi and Iqbal's views about the special intrinsic nature of the Islamic banking get crystallized into an Islamic universal banking model[57] (Al-Jarhi et al. 2001) wherein an Islamic universal bank,[58] portrayed as a multipurpose bank, culminates in 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 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

57 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.

58 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, *mu*da*rabah* deposits, and *wak*a*lah* deposits (clients deposit funds in the *wak*a*lah* account on the basis of *wak*a*lah* 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., *mu*da*rabah* (passive partnership), *mush*a*rakah* (active partnership), diminishing partnership, *mur*a*bah*a*h* (sales contract at a profit markup), *ij*a*rah* (leasing), a lease ending in the purchase of the leased asset, *al-istisn*a[(contract of manufacture) and *al-istisn*a[*al-tamwili* (financing by way of *al-istisn*a[ ), and *salam*].

will enforce financial controls,[59] operational controls,[60] and Shari[ah compliance by instituting a Council of [ulama' at the national level for Shari[ah-audit and for issuing fatawa (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 (bay[) and/or in use (ijarah), or create assets which give rise to the flow of income (that is, 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 (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 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 Shari[ah according to which Allah (Subhanu Hu Wa Taa'ala) is the absolute owner of wealth and the wealth (for example, the Islamic Bank and assets of this bank) is entrusted by Him to the mankind as a trust under terms of trusteeship for serving Him. This concept culminates in a unique

59 For example, 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.

60 For example, the application of consolidated and acceptable Islamic accounting standards, a review of project financing operation, and an evaluation of the performance of banks.

Islamic corporate culture[61] consisting of numerous stakeholders[62] 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 mudarabah financing as well as musharakah financing, which are perceived as equity investments, and the rarely allowed principle of markup which is used for commercial financing in the form of murabahah financing and ijarah financing. The Islamic bank (trustee) operates an interest-free current account, the saving account on a safe-keeping basis, and musharakah-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,[63] internal control systems,[64] and external regulatory system.[65]

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 mudarabah/musharakah account holders (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

61 The Islamic corporate culture establishes appropriate behavioral standards for all stakeholders, motivates them, governs their internal relations within the organization (employer-employees relationships) as well as external relations (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.

62 In this context, there coexist 7 categories of mutually functionally integrated key stakeholders (shareholders, management, *mush*a*rakah*-financing parties, partners in *mu*da*rabah*-based investments, current account holders, employees, and Islamic community).

63 Constituents of the internal regulatory systems are board of directors, non-executive directors, audit committee, internal audit, Shari[ah supervisory board, and judicial advisor.

64 Constituents of the internal control systems are financial controls, operational controls, audit reviews, compliance with reporting standards, and Shari[ah compliance.

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

maintaining the level and inflow of investment deposits. The imperative of signalling the profitability and its stability to the depositors restricts mangers' 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 (insiders and outsiders).

Anjum (2005) presents a design of a progressive pan-Islamic monetary model by outlining its systemic goals, rationale, politico-economic framework, the nature/scope/benefits/costs of the proposed Islamic monetary unit (Islamic) Universal "Ψ", 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 Shuratic (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 (maqasid) of the Islamic system namely security and advancement of life, religion, intellect, offspring and wealth. He lists the Islamic monetary regime's goals (the progressive needs[66]-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[67] of the Islamic monetary system) which are to be prioritized through Muslim Ummah/grassroots-level Shuratic process[68] 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.

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 (Government of all governments) envisioned

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

67 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).

68 Choudhury interprets the term *Shuratic* process as the institutionalized process of extensive discursions in Islam (Chaudhury, 1997).

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[69] in the context of safeguarding[70] the socioeconomic interests of different states and establishing peace and justice among them. He argues that the existing vacuum[71] in the area of a vehicle currency justifies the contemporary 57 Islamic countries' proposed policy action of simultaneously abolishing their weak individual currencies and jointly instituting as well as promoting an official Islamic vehicle currency[72] (Ψ) for preserving developing, controlling and utilizing their own colossal wealth by promoting their progressive pan-Islamic global monetary regime instituted for the politico-economic empowerment of all humans on the global level. This policy action of all the Islamic countries will reduce the avoidable huge costs of inefficiency[73] (transaction costs/calculation costs) in the monetary and real sectors of the Islamic countries. This outcome will increase human welfare by reducing risk/uncertainty/vulnerability and generating monetary efficiency gains, due to elimination of the costs of converting one currency into another.

For accomplishing optimal monetary management in the dynamic framework of a

69 Keeping in view the prevalent universal consensus on the sanctified status of *al-Hararamain al-Shareefain* among all Muslims of the world, all the contemporary Islamic countries may get completely integrated under the Islamic Caliphate as well as the Khilaaftul-Khulafa headed by an Arabian *Khaadimul Haramain al-Sharifain* i(Servant of Two Holy Mosques) in order to meaningfully revive the unparalleled power of Muslim *Ummah*.

70 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 *Khilafat-ul-Khulafa* (Central Islamic Government of all Subordinate Islamic Governments) 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.

71 Unfortunately, this vacuum is due to the failure of the governments of the individual Islamic countries in providing the urgently needed alternative vehicle currency.

72 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 "Ψ", is expected to reinforce the strength as well as the confidence commanded by Ψ not only within the boundaries of *Khilafat-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, Ψ has the potential to assume the character of a truly universal currency.

73 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.

growing Islamic economy, 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 realization of the above Islamic macroeconomic goals[74].

Islamic Monetary Authorities Network (IMAN[75]), proposed to be constituted by Khilafat-ul-Khulafa, will accomplish progressive monetary management in a pan-Islamic universal economy. The optimal Islamic monetary management regime consists of IMAN, Islamic treasury[76], Islamic Consensus-Based Banks (ICBBs[77]), Islamic money

74 That is, price stability, growth, full-employment, equitable distribution, and human development.

75 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 ‘ Ψ› 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.

76 Islamic treasury may issue a small amount of currency in the form of all coins.

77 ICBBs are modelled along the lines of Islamic consensus-based banking which is explained in this paper's section entitled Conclusion and Policy Recommendations.

demand function[78], and the Islamic money supply function[79] which is equilibrated with the aforementioned Islamic money demand function, and a progressive Islamic monetary transmission mechanism[80]. But, 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 Shuratic (consultative) process.

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78 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* (Islamically allowed) Real Goods and Services meant for moderate consumption and productive investment with in Islamic limits, y_m stands for the rate of return on IMAN's *mu*da*rabah/mush*a*rakah*-based investments of shortest maturity, I indicates the Islamic institutional factors (for example, *sh*u*ra, zak*a*h, taqwa* (fearing from Allah), austerity, justice (absence of injustice and exploitation), moderation, cooperation in the form of *mu*da*rabah/mush*a*rakah*-based investment, Islamic Common Market) which could be measured by using a proxy in the form of sum of reduction in both investment/production/transaction costs and consumption expenditures due to elimination of inflation/taxation/corruption/wastage (*israf* (extravagance) and *tabzir* (superfluous consumption) represented by a significant reduction in the quantity of demand for money due to institutional factors and T_F symbolizes the state of financial technology (for example, the innovative use of debit cards). In the above context, Islamic public treasury has an important role to play by ensuring both the moderation of government/public expenditures and tax/tariff-free competitive trade within the framework of a universal Islamic common market from the point of view realizing perfectly elastic adequate supply of *halal* goods and services and precluding the possibility of inflation.

79 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.

80 The following 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:

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 *mu*da*rabah/mush*a*rakah* or *al-qar*d *al-*h*assan.* 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 (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 → increase in y_m → increase in prices of shares → increase in both consumption expenditures and productive investment → increase in GDP of *Ummah*).

According to the Islamic money supply rule, IMAN will estimate the Islamic objectives (al-maqasid al-Shari'ah)-based annual aggregate demand for money or its estimated annual growth rate. Then the estimated Islamic objectives (al-maqasid al-Shari'ah)-based annual aggregate demand for money (or otherwise its estimated annual growth rate) will be targeted to be equilibrated with supply of base money alone[81] (or otherwise its annual growth rate) for satisfying the following monetary equilibrium condition:

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

IMAN must supply money by following the rules of treating money supply as fai in light of innovative insights provided by Chapra/Al-Jarhi/Ansari and allocating its created money among the various stakeholders[82] by strictly implementing the interest-free Islamic rules of supplying money on the basis of mudharabah/musharakah/al-qrdh al-hasan and exceptionally on the basis of salam/salaf and istisna' contracts[83] in exceptional cases by invoking the Islamic rule of istihsaan (equity)[84]. The Islamic rules of noninflationary money supply will ensure the most progressive, productive and equitable use of the money created by the Islamic central bank through institutionalization of constructive money-real economy linkages, which will culminate in acceleration of equitable economic growth, full employment and development of all members of Ummah.

Efficacy of the Islamic money supply rule can be enhanced by effectively planning/targeting/managing/monitoring/auditing the money supply, equitably allocating it among stakeholders, controlling it through regulation of Islamic banking institutions for ensuring their competitiveness/cost-effectiveness/efficiency[85]/transparency[86]/openness[87]/accountability[88] and the stability of the Islamic banking/monetary/economic

81 This scenario originates from the proposed elimination of the power of banks to create inside money in the Islamic economy.

82 For example, *Baytul Mal* (Islamic public treasury), private sector including small/medium/large enterprises and corporations, and voluntary sector..

83 These contracts must ensure the satisfaction/implementation of all Islamic stringent conditions of validity of *salam*/*salaf* and *istisna'* contracts in their letter and spirit.

84 Mansoori (2007).

85 That is, reduction of transaction costs and costs of Islamic banking services through cooperative competition.

86 That is, disclosure of all transactions and decision-making.

87 That is, openness to innovation and new technologies.

88 That is,

system (Edmister, Choudhury et al. and Rehman et al., Abbassi et al.)[89].

The above models of Islamic banking are living examples of ijtihad of contemporary Islamic jurists. ICBB is an ideal paragon, which is a product of simultaneous application of all sources of Shari'ah – the Holy Qur'an, the Sunnah, Ijma' (consensus of jurists), and ijtihad based on Qiyas (analogy).

5. Conclusion and Policy Recommendations in Light of Ground Realities

This inquiry into the alternative models of the Islamic banking manifests the humane, social, dynamic, innovative, progressive, equitable and universal character of the Islamic banking. The panorama of crystallization of several distinct multi-faceted theoretical models of the Islamic banking as the variants of the originally published two-tier mudarabah model of the Islamic commercial banking is a result of the continuous feedback/feedforward between theory and practise of the Islamic banking, which have been enriching the literature on the subject. However, 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 constituents[90] of the Muslim Ummah.

The first 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. Against this background, ICBBs are modelled along the lines of Islamic consensus-based banking which accomplishes

89 In this context, it is pertinent to note that Rehman and Mangla have empirically confirmed the contribution of *Shari'ah* Board to value based corporate governance of Islamic banks in Pakistan by identifying the empirical fact that the presence of *Shari'ah* Board affects the return on equity and technical efficiency of the banking sector in Pakistan. Abbassi et al. empirically confirmed that the Islamic work ethics and the Islamic leadership model (model of governance by example), contributed towards total value based governance and, thereby, ensured value for all stakeholders – shareholders, employees, customers, and society. They found positive relationship between ethics and values, management performance and organization value in case of Pakistan. A theory of Islamic corporate governance, which is contributed by Choudhury and Hoque, asserts that transactions cost minimization is a practical implication of the Islamic corporate governance, which is characterized by a discursive process, transparency and institutional participation.

90 For example, 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.

corporate governance-oriented Islamic universal banking by using only those modes of the Islamic banking and financing[91] which command the general consensus among the Islamic jurists and economists and, thereby, the confidence of the global Muslim community. 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 musharakah and mdrarabah.

ICBBs, on their liabilities' side, can institute checkable demand deposits on the basis of 100% reserve requirements and mudarabah deposits/musharakah deposits/wakalah deposits/swift sadaqaat disbursement accounts/firm commitment-based participatory deposits[92] 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'/mudarabah//musharakah/share-cropping-based musaqah and muzara[ah, 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 (services of money transfer, bank drafts, letters of credit, share brokerage, traveler's cheques). On the basis of mudarabah/musharakah/share-cropping-based musaqah and muzara[ah, ICBBs can introduce financing instruments of equity participation, mudarabah certificates, musharakah certificates, musaqah certificates, muzara[ah certificates and al-qard al-hasan 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[93], equitable, perfectly see-through/transparent/disclosed,

91 For example, *musha*r*akah* and *mu*da*rabah.*

92 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.

93 That is, high-tech/efficient and service-oriented.

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 against the background of the persisting widespread misconceptions/skepticism in the context of resemblance between certain practises of contemporary Islamic banks and the practices 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 mudarabah. ICBB will popularize the Islamic banking , empower/develop the humanity, and marginalize those Islamic banks, which misuse Shari[ah tricks.

Muslim masses' built-in-confidence in ICBBs will be the vehicle asset of the system of ICBB which will globalize the practice 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. For achieving the long-term developmental goals, implementation of 'increasing musharakah' and the following principles is recommended:

- *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.*

Above all, 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 for instituting an ever-popular regime of the Islamic consensus-based banking system. This system can standardize the Islamic banking procedures/services/products, generate and exploit social capital, command the confidence of the global masses, and provide the financial fuel to engines of universal economic growth and human development.

For ensuring that ICBB commands an unshakable confidence of all stakeholders of Muslim Ummah, the Governments of contemporary Islamic countries (Malaysia and Pakistan) must end dualism in their central banking regime, which is manifest in the coexistence of the dominant capitalist interest-based central banking system along with a nascent, frail interest-free central Islamic banking system, by having only an one interest-free Islamic central banking system. This system must conduct an Islamic monetary policy in coordination with the country's Islamic treasury as well as accomplish rigorous regulation of the Islamic banking practices of its member Islamic banks in perfectly transparent ways under an autonomous proactive Shari'ah Board[94]. This will rule out the indulgence of the governments, Islamic banking institutions and their functionaries in misuse of their financial resources[95].

Islamic banking[96] is distorted by dual banking system, which works under a secular governor of central bank and other top secular bankers imported from the global capitalist institutions, who deny level-playing field to ICBB and generally undermine the effectiveness of Islamic banking laws and the authority of members of Shari'ah Boards of ICBB. ICBB must ensure recruitment of only the Islamically well-qualified employees by the Islamic banks.

A litmus test of success of the Islamic Consensus Based Banking System is that it precludes any possibility of its involvement in extractive and exploitative activities.

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94 It must be ensured that members of *Shari'ah* Board are not dependent on the banking system for their appointment/salaries/perks and that they have a mandate for ensuring strict Islamic compliance by the Islamic central bank and its member banks in letter and spirit.

95 For example, State Bank of Pakistan, Bank *Islami* and Dubai Islamic bank have and finance their own regular cricket teams. Such games of especially the Islamic banks are a clear violation of their mandate of achieving *al-maqasid al-Shari'ah*, as such games are vehicles of promoting the culture and values of secularism and imperial capitalism.

96 For example, Government of Pakistan's current practice of taxing withdrawal of sums exceeding 50,000 Rupees from the current accounts of Islamic as well as capitalist banks gives rise to negative riba (interest) from the point of view of current account holders of the Islamic banks as their current account deposits are reduced by the amount of tax.

For enabling the system of ICBB to pass this litmus test, it is recommended for the Governments of the Islamic countries to jointly constitute a permanent autonomous Global Council of Islamic Jurists (GCIJ) responsible for continuously accomplishing detailed research-based informed ijtihad by minutely scrutinising all issues and aspects of the fast evolving dynamic system of ICBB on the bases of the aforementioned sources of Shari'ah within the framework of a universal shura – a global Islamic consultative body – consisting of the true representatives of all stakeholders of the system of ICBB. Governments are required to be constitutionally responsible for ensuring the perfect enforcement of all judgements of GCIJ through the proactive roles of their Shari'ah boards, Islamic banking ombudsmen and Shari'ah courts as well as directly monitoring and regulating all the banking activities/ transactions of ICBBs for protecting and promoting the Islamic interests of all stakeholders of ICBB.

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