
A Comparative Study of the Role and Functions of Conventional and Islamic Central Bank

Dr. Hafiz Moazzum Shah

Lecturer, Shariah Department,
Allama Iqbal Open University Islamabad
smoazzum@gmail.com

Abstract

The central bank stands at the top of the banking hierarchy in every country and is empowered to perform important functions such as issuing and regulating currency notes, monitoring banks operations and their credit policies. In most countries, it is also authorized to formulate and implement monetary policy according to the guidelines provided by the government. Central banks are among the most important players in financial markets throughout the world. There are many factors that affect the economic stability at national and international level. Apart from the modern banking system and their crucial role in the economy, the invention of derivatives, future and forward sales, future markets capital markets and money markets have brought evolution in financial world. Moreover, there is conflict between the role, functions and objectives of these newly introduced instruments and markets. Many of these factors affect the supply of money. Therefore, there must be an institution that regulate them and minimize the negative effects of such economic activities in money and capital markets. Islamic central bank will apparently play almost the same role as a conventional central bank. However, the main factor that makes difference between the two is interest which is prohibited in Islam hence, cannot be practiced by an Islamic central bank. Most of the monetary and other tools used by the central banks to perform its duties

and carry out its functions include *Riba*. Thus, an Islamic central in a modern economic system has to achieve the same objectives and perform same duties as a conventional bank performs. However, it has to use tools other than those generally used by a conventional central bank. This article proceeds with understanding the concept of Islamic central bank. The second part discusses the functions and role of an Islamic central bank to determine that how it is different from a conventional central bank. The last part consists of some important findings of the research

Key words: Central bank, Islamic Central bank, conventional bank, comparative study

The Concept of Islamic Central Bank

Various contemporary Muslim scholars have defined Islamic central bank.

Dr Umar Chapra says:

“It should be an autonomous government institution responsible for the realization of the socioeconomic goals of the Islamic economy in, and through, the money and banking field”¹

This definition says that an Islamic central bank must be an autonomous body and is responsible to achieve the socioeconomic goals through money and banking field. This is the definition of a central bank by highlighting the goals and objectives of central bank. If we compare this definition with the definition of a conventional bank, we can assume that this is not a clear comprehensive definition. The definition of a conventional bank is:

“It is the institution that undertakes the responsibility of issuance of the banknote and ensures, by various means, the soundness of the banking system. It is (also) entrusted with supervision over the credit policy of the country as these policies have important impacts on the economic and social system”²

This definition is better and depicts a complete picture of the central bank. The definition of conventional bank may be applied to the Islamic conventional bank, as an Islamic central bank undertakes all the responsibilities mentioned in the definition of the conventional bank.

For example, in the definition of conventional bank it is mentioned that this institution undertakes the responsibility of issuance of currency and ensures the soundness of the banking system using various means. This concept does not contradict with shariah principles and does not violate any shariah rule. Moreover, the role of a central bank mentioned in this definition is also expected from an Islamic central bank in the modern economic system. Thus, the concept of a central bank is same as of a conventional central bank.

However, what make difference are the tools used and ways that are practiced by the central bank. Once we are convinced that the concept of a central bank is same in both Islamic and conventional monetary system, then the definition presented by Zakki Shafi is more comprehensive and clearer.

Analysis of the Definition

Yet we can deduce the most important characteristics of a central bank from the definition of Dr Umar Chapra.

Firstly, it must be autonomous body. It means it must maintain its internal management system and governing body. This is necessary to

ensure the efficient performance of the Islamic central bank. Moreover, it must be an independent body. This is a necessary condition for an Islamic central bank to perform its duties and take decisions in the best interest of the economy and there must not be any type of political interference or pressure from any other government authority.

To ensure its independence in taking decision, it must have its own resources and income sources. These sources may be in the form of remuneration received by the central bank against different types of agency and other services to government and other banking institutions. It may also invest the funds received from commercial banks as reserve ratio on the basis of *Musharakah* or *Modaraba* and get its share of profit from such investments.

Secondly, it must be a public entity owned by the government. The reason why it must be owned by the government is that it performs an important duty of issuance of currency. All the Muslim Jurists are unanimous that authority of issuance of currency in Islamic economic system must remain with the government and it must have a monopoly over it. Any private entity must not be allowed to issue currency as this will lead to economic instability. The famous Muslim historian and Jurist Ibne Khaldoon says:

“The head of the state is charged with repairing of coins and is responsible to save them from any type of loss or damage.”³ We have shed light on this issue in detail in second chapter under the topic “issuance of currency.”

According to Imam Ahmad coins must be minted in Islamic minting house with the permission of the head of state because if public is allowed to mint the coins it will lead to harm to them.⁴

Another Muslim jurist of Hanbali School of thought Imam Ibne taymiyyah is of the view that the head of the Islamic state is responsible for minting of coins for the people.⁵

Moreover, it has to formulate and implement policies to achieve the objectives of socioeconomic goals. These objectives cannot be achieved by a private entity.

Thirdly, what can be deduced from this definition is that there must be only one institute entrusted with the authority of issuance of currency. This is because more than one institute cannot formulate and implement the policies. It will be difficult to formulate and implement harmonized policies if there is more than one institute performing same role. However, the central bank may be allowed to establish branches in various regions and regions, in order to facilitate and perform its duties through division of tasks and responsibilities.

Functions and Role of an Islamic Central Bank

The functions of a conventional central bank have been mentioned above. The Islamic central bank will play almost the same role and carry out same functions. Dr Umar Chapra says

“Like all central banks, the Islamic central bank should be responsible for the issue of currency and, in coordination with the government, for its internal and external stability. It should act as banker to the government and the commercial banks”⁶

The main role and assumed functions of an Islamic central bank are same as of a conventional central bank. Islamic central bank will coordinate with government to take steps to ensure internal and external economic stability. It will be responsible for issuance of currency keeping in view the economic condition and monetary policy requirements.

It must act as banker for banks and must make necessary and suitable arrangements for settlement of debts and clearance of checks. It will also take all necessary measures to supervise the commercial and specialized banks. It will ensure the soundness of all banking system.

We will discuss the supervisory function of the central bank in detail.

Supervisory Function of an Islamic Central Bank

The main objective of a central bank's supervision over the banking system is to ensure the safety of the interest of the general public and the bank's share holders. The central bank takes steps and issues instructions to save the commercial and specialized banks from default risk.

The risks, faced by any business, are primarily related to the nature of that business. Islamic banking has a different nature from the nature of conventional banking. The basic difference is that the relationship of a conventional bank with his customer is a loan based relationship. The bank does not share the risk of loss with the customer. There is only risk of default or bad debts. As for as the Islamic banks are concerned, the relationship between bank and customer is based on investment and risk sharing. The investment activity represents the core and essence of its nature and is a backbone of Islamic banking system. The investment activity has a methodology and mechanism of action that is different from the methodology and mechanism of the loan based system on which the conventional banking system activity depends. The nature of relationship of a supervisor, like central bank, with both banks through these two different activities is different in terms of its nature, methods and provisions. This difference in the nature of the investment activity and the nature of the supervisory relationship with its customers in the Islamic bank results in existence of different types of risks that an Islamic bank may be exposed to.

The customer himself may be a source of many risks for bank if he does not have the required level of administrative and investment experience essential to ensure the efficient and successful implementation of the project. Moreover, if he lacks proper professional conduct of business necessary to preserve the bank's funds from any loss, it will be a risk for Islamic bank. These types of risks arise due to the nature of relationship between an Islamic bank and his customer. This relationship is based on profit and loss sharing. Unlike the loan based relationship that makes the conventional bank safe from these types of risks, because the amount given to customer is a debt owed by the customer that must be repaid to the bank in all cases. On the other hand, funds provided to the customers of Islamic bank are not guaranteed. There is risk of loss which the bank has to share with the customer.

Since the nature and level of the risks to which the Islamic banking business is exposed to is different from the nature of the risks to which the traditional banking business is exposed to as mentioned earlier, and since the Central Bank establishes its methodology of supervision on the basis of this nature of risks, the methodology of supervision for conventional banks must be different from the Islamic banks. A methodology adopted for conventional banks cannot be considered appropriate for Islamic banks, and the methods that the Central Bank relies on to reduce these risks are not suitable for achieving this goal in the case of Islamic banks.

Credit Guarantee Policy of Central Bank for Islamic Banks

The central bank issues instructions to commercial and specialized banks to ensure the guarantee of the loans given to customers in the form of collateral or pledges. This policy, if applied on the Islamic banks, is not suitable for controlling the risks of Islamic banking, except in the event

that the relationship between the bank and the customer turns to debt relationship which happens very rarely when the customer guarantees payment of the bank's funds. This situation happens when there is *Qarz Hasan* contract between bank and the customer. The portion of such contracts in Islamic banking activities is very low.

Another case, where the principal amount is guaranteed for the bank and is to be returned by the customer, is when the contract of *Musharakah* or *Mudharabah* becomes void. For example, this case may occur, if the partnership relationship between the bank and the customer turns into a void contract, when anyone of the contracting parties violates the terms of the relationship or make misuse of the bank's funds. These types of cases are actually exceptional cases.

Actually, Islamic banks are more concerned about the profit rather than the guarantee of the loan provided to the customer. If a customer is going to invest funds in a business which is expected to return high profit, the Islamic bank will be willing to create partnership relation with him even he does not have the traditional forms of guarantees.

Hence, this policy is not suitable to achieve the goals for which it is applied in the case of Islamic banking, which is to control the risk of default. In addition to the fact that its application to these banks limits their ability to grant financing to certain sectors and people of the society who meet the requirements for obtaining this financing according to the methodology work of these banks, however, they are unable to provide these types of traditional guarantees required by the central banks.

The Policy of No Ownership of Fixed and Moveable Assets For Investment Purpose

The banks are not allowed to own fixed and moveable assets for investment purpose.

This policy, of not allowing the ownership of fixed and movable assets, is not appropriate for the Islamic banking business as well, as Islamic banking business depends on investment as a main activity for the employment of funds, which requires the ownership of these assets. In fact, most of the Islamic modes of financing are asset based activities. Restricting Islamic banks from such type of ownership would be a major obstacle in performance of this activity. This is because Islamic bank does not deal in money only, rather it is a business entity. It owns and sells goods. It enters into partnership contracts with customers.

Thus, application of this policy to Islamic banks is not consistent with the nature of their activities and the nature of the risks to which their activity is exposed.

Dr Abdul Munim says:

"إن إختلاف طبيعة و نوعية المخاطر التي تواجه العمل المصرفي الإسلامي عن المخاطر التي تواجه العمل المصرفي التقليدي تجعل منهجية و أساليب الرقابة التقليدية للبنك المركزي غير ملائمة للتطبيق على حالة المصارف الإسلامية وغير قادرة على تحقيق الأهداف المطلوبة كما أنها تمثل معوقاً رئيسياً لأنشطة هذه المصارف في كثير من الحالات"⁷

The difference in the nature and quality of the risks in Islamic banking business from that of the conventional banking business makes the traditional methodology and methods of control of the central bank, inappropriate for application in Islamic banks and is unable to achieve the required goals, as it is a major obstacle to the activities of these banks in many cases.

Here dr. Munim has emphasized on the importance of adopting different methodology for the supervision over Islamic bank due to difference between the nature of the Islamic and conventional banking system. The nature of the risk faced by Islamic bank is different from the

risk the conventional bank is exposed to. If the supervision methodology applied on conventional banks is applied on Islamic banks, it will be an obstacle in the way of Islamic banking system. Thus, methodology of conventional central bank to supervise the banking system would be different from that of conventional central bank.

Islamic Central bank as lender of the lost Resort

In addition to the above mentioned supervisory aspects, the central bank is required to perform the function of lender of last resort in a way that is consistent with the nature of the activities the of Islamic banks in case of both liquidity and solvency crises. We have discussed above, under the functions of conventional central bank, that the central bank plays its role as lender of last resort. The Islamic banks may feel, sometimes, lack of liquidity problem.

Liquidity crises may arise because, the Islamic bank, after investing an amount in a project, may not be able to receive that amount and profit as per planned and expected maturity period and gets late. In this situation, the bank may face the liquidity problem. Insolvency on the part of an Islamic bank may occur, however, the possibility of occurrence of such insolvency is very low, because of substantial volume of *Mudharabah* deposits. *Mudharabah* is an agreement in which funds are provided by one party for investment and the other party is responsible to use his labor and professional skills to generate profits⁸. Thus, deposits with bank on *Mudharabah* bases are generally sufficient to protect demand deposits.

Yet, if the central bank deems it necessary to help an Islamic bank facing liquidity problem, it will help him on the basis of *Qrzan Hasan* contract which means giving loan without interest as interest is prohibited in Islam.

Credit Allocation

A conventional Central bank also plays a distributive role in the economy. Distributive role means that it develops different policies for different sectors of the economy. Each policy may have different effects on each of the various sectors of the economy. credit allocation means that the central bank determines ceilings over the credit facility extended to different sectors of the economy. For example, the central bank may put a condition that a commercial bank cannot provide credit facility for car financing or for construction purpose. The main objective of such instruction is to achieve the goal of stable economy through its distributive role by concentration on each sector of the economy.

As for as an Islamic banking is concerned, one may raise the question, is it allowed for a central bank from shariah point of view to put such conditions upon an Islamic bank? Is it consistent with the basic rule of Islam which says that everyone is free to spend his wealth and invest his money in any sector as long as it is not against the shariah rules?

Apparently, it is not allowed to stop someone from investing his amount in a field of his choice, so central bank is also not allowed to put condition on banks preventing them from investing his funds in a specific sector of the economy. This is against the right of individuals to dispose of his wealth as, when and where he wishes as long as it does not contradict the shariah principles and public interest.

In fact, one of the main objectives of shariah that can be derived and deduced from the shariah provisions related to every field of life, is interest of public.

The famous Muslim Jurist Ibnul Qayyim says:

"إِنَّ الشَّرِيعَةَ مَبْنَاهَا وَأَسَاسُهَا عَلَى الْحِكْمِ وَمَصَالِحِ الْعِبَادِ فِي الْمَعَاشِ وَالْمَعَادِ"⁹

Islamic Shariah is based and built on wisdoms and public interest in this world and the world hereafter.

It is the responsibility of an Islamic state to intervene in the economic activities to ensure safety of public interest. If any sector of the economy is being ignored by the investors and this ignorance may result in economic instability in the country, the government is responsible to take necessary steps and measures to save that sector of economy. The government is allowed to intervene and impose some conditions upon individuals to save that sector to ensure public interest even if the action goes against right of individual interest in their use of wealth according to their will and preferences, an already accepted right by Islam¹⁰. This is because public interest and rights have preference over private rights. Therefore, Monopoly is not allowed in Islam because it is against the public interest.

There is Hadith of Prophet

"لا يمتكر إلا خاطئ"¹¹

"No one withholds goods till their price rises but a sinner."

In the light of above discussion, government is allowed to issue instructions to the banks to ensure economic stability in the country even if they are deprived of their right of freedom with regard to the use of his wealth according to his will. Thus, this intervention by the government is not against the provisions of shariah.

However, it would be preferred to attract investors to invest in the sector which the government want to prefer over the other and should avoid direct instruction to prevent form investing in some sector of the economy or imposing conditions to prevent them from investing in some sectors of the economy.

Issuance of Currency and Money Supply Control:

One of the basic functions of an Islamic central bank is to issue currency and maintain the value of money at a suitable, stable and desired level. There is no disagreement among Muslim jurists that the state - and only the state - is the authority in issuance of currency and it is not permissible for anyone to perform this task.

According to Imam Ahmad coins must be minted in Islamic minting house with the permission of the head of state because if general public is allowed to mint the coins it will lead to harm to them.¹²

Another Muslim jurist of Hanbali School of thought Imam Ibne Taymiyyah is of the view that the head of the Islamic state is responsible for minting of coins for the people.¹³

As we have mentioned before, Abdul Malik Bin Marwan is the first caliph in Islamic history who formally minted gold and silver coins in 76AH called Al-Dirham Al-Islami and al-Dinar Al Islami. He also restricted the process of minting coins to the central government.¹⁴

An Islamic central bank is also responsible for issuing of currency and maintaining its value. It will also insure steady economic growth. It is a primary institute in the state to formulate and implement the monetary policy. It will use whatever instruments, tools and method necessary for a successful monetary policy as long as they are not in conflict with teachings of shariah. For example, Islamic central bank is not allowed to use interest as a tool for monetary policy as interest is prohibited in Islam.

Allah Says in the wholly Quran:

"أحل الله البيع و حرم الربو"¹⁵

"But Allah hath permitted trade and forbidden usury".

Likewise, it cannot take any a step that is considered against the public interest or have a positive effect only on specific class of the society ignoring other classes as this is against the social justice doctrine of Islam.

Allah says in the Quran,

"إِنَّ اللَّهَ يَأْمُرُ بِالْعَدْلِ وَالْإِحْسَانِ وَإِيتَاءِ ذِي الْقُرْبَىٰ"¹⁶

"Indeed, Allah orders justice and good conduct and giving to relatives."

Moreover, if a policy is formulated which benefit only rich people it will also be considered against the teachings of Islam. Islam emphasizes on distribution of wealth and does not want wealth to be concentrated in few hands of society. Another verse in the Quran says:

"كَيْ لَا يَكُونَ دُولَةً بَيْنَ الْأَغْنِيَاءِ مِنْكُمْ"¹⁷

"So that it will not be a perpetual distribution among the rich from among you."

According to the teachings of Islam, the deprived and poor people of the society must be given priority and special attention by the state to ensure equitable distribution of wealth. Thus, the central bank should formulate monetary policy, keeping in view the basic concepts and teachings of Islam as referred above.

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