AN ANALYSIS OF *SYUBHAH* IN ISLAMIC BANK'S MONEY CREATION

AHMAD YANI ISMAIL*
Faculty of Management and Muamalah
Kolej Universiti Islam Antarabangsa Selangor (KUIS)
ahmadyani@kuis.edu.my, 017-3712488

DR. ABDULLAAH JALIL
Faculty of Economy and Muamalat
Universiti Sains Islam Malaysia (USIM)
abdullaah@usim.edu.my

*Corresponding author

ABSTRACT

The aim of this article is to analyse bank's money creation via financing products in the context of *syubhah*. Writers and researchers have examined bank's money creation from economic perspective. Few Islamic researchers and scholars have also studied the matter analysing it from *Maqasid Shariah*. This study specifically examining Islamic bank's money creation and analyse it in the context of *syubhah*. This is the contribution of this research. In the attempt to analyse bank's money creation in respect of *syubhah*, the researchers employ library research method. Published articles in various journals, quotes from global prominent practitioners, established textbooks and translated books from original authors are examined. Based on the literatures and analysis, the authors are of the opinion that bank's money creation can be categorised as *syubhah*. From the contract perspective, all factors have been considered by the Shariah Advisors to alleviate the element of *riba, gharar* and *maysir*. However, looking from the implication of money creation, it has its footprint in financial crisis, inequality and injustice. To manage banks' money creation by Islamic banks, the authors propose a Shariah compliance framework. The researchers also urge more empirical researches need to be conducted on the matter.

Keywords: Islamic Banks, Money Creation, *Syubhah*, Financing Products

1. Introduction

> *"The financial crisis of 2007/08 occurred because we failed to constrain the private financial system's creation of private credit and money."*
>
> Lord Adair Turner (2013),
> Former Head of the United Kingdom Financial Services Authority
> Former member of the Bank of England's Financial Policy Committee

> *"The proof that Islamic banks engage in money creation will be that the 'Islamised' economies of the Muslim world suffer the same inflation and boom-bust cycle that is evident in the west."* (Al-Haddad and Eldiwany, 2008).

Bank's money creation that originates from Fractional Reserve Banking (FRB) system as the core operational mechanism for modern banking system has been the subject of debates among the conventional banking stakeholders since the 1929 U.S.A Great Depression. The debates revolve around money creation by Central Bank which is also refers to as Quantitative Easing (QE), the printing of notes and coins (i.e. fiat money), money created by private commercial banking industry and money created by individual private commercial banks. This research focus on the money created by the individual private commercial conventional banks via consumer financing products. The proponents asserted that money creation, which most of them refers to Quantitative Easing, has savaged countries' budget deficit (Coplin & O'Leary, 1985; LeLoup, Dietz, Hogye, Papai, Urban & Varadi, 1998; Ghosh & Mourmouras, 2001; Azam & Emirullah, 2014) and provided stability in financial systems (Swamy (2014). The dissidents, including Rowbotham (1998), Hickson & Turner (1996), blamed private commercial bank's money creation for monopolistic, environmentally damaging, lead to unemployment and business crises. Meera & Larbani (2006, 2007) and Abdullah (2016) blamed FRB for bankrupting financial institutions. As a result of the U.S.A.'s Great Depression in 1929, calls were made to replace the FRB system with full Reserve Banking system in the detailed documents named Chicago Plan (Phillips, 1992). Phillips (1992) argued the plan failed due to political manoeuvre. At the back of the 2007-2008 sub-prime crisis, the reform proposed in Chicago Plan was recalled and supported by the International Monetary Fund (Benes & Kumhof, 2012). Private bank's money creation is identified as one of the sources of financial crisis (Turner, 2012; McLeay, Radia & Thomas, 2014).

The introduction of Islamic Banking has also attracted debates on FRB system and money creation among the Muslim researchers. The study centred around FRB system and money creation from the perspective of Shariah, whether or not it achieved *Maqasid al Shariah* and examining from the *mafsadah* and *maslahah* aspect. Meera & Larbani (2009), Sani, Arfah, Meera & Aziuddin (2013) and Al Twijri (2016), for example, recorded that FRB is haram and contradicts with the *Maqasid Al-Shariah*. This is in congruent with Ismail (2019) who asserted that money creation violates the principle of *ar Rawaj*, an important element for achieving the principle of *Hifz al Mal*. Syamlan (2016) and Ismail & Tohirin (2017) argued that Full Reserve Banking system will eliminate the element of injustice and *riba* hence attaining the *Maqasid Shariah*. Syamlan (2016) also concluded that FRB system has more *mafsadah* dan *maslahah*. Consequently, this article will provide an analysis of *syubhah* in FRB system-based private money creation. This is the significance of the study and contribute to the knowledge and the intellectual discourse on FRB system and money creation.

2. Research Method

In research inquiry, depending on the research objectives the researchers may adopt either quantitative, qualitative and mixed inquiry (Creswell, 2009). In this particular study, the researchers opt for qualitative document and content analysis by investigating peer reviewed articles pertaining to bank's money creation, Fractional Reserve Banking system as well as analysis from the *Maqasid al Shariah* and Islamic perspective. The authors established analysis of *shubhah* vis-à-vis bank's money creation and Fractional Reserve Banking system as the gap.

3. Money Creation by Conventional Banking Industry

"The key function of banks is money creation, not intermediation."

Michael Kumhof, Deputy Division Chief, International Monetary Fund

"When banks extend loans to their customer, they create money by crediting their customers' accounts."

Sir Mervyn King, the Governor of the Bank of England from 2003-2013

"The banks do create money. They have been doing it for a long time, but they didn't realise it, and they did not admit it. Very few did. You will find it in all sorts of documents, financial textbooks, etc. But in the intervening years, and we must be perfectly frank about these things, there has been a development of thought, until today I doubt very much whether you would get many prominent bankers to attempt to deny that banks create it."

H W White, Chairman of the Associated Banks of New Zealand,
New Zealand Monetary Commission, 1955.

It is a fact that the modern banking system operating on FRB system has resulted in money being created from nowhere (Rowbotham, 1998; Meera & Larbani, 2009; Hassan, 2008)). Thus, all mainstream global conventional banks undoubtedly have been creating money from nothing (Meera et al., 2009); Standard and Poor's, 2013). Such bank's money creation occurred every time banks disbursed the loan amount to the borrowers (Standard and Poor's, 2013; Werner, 2014a). This fact is supported by statements by prominent global banks' regulators and policymaking authorities from Canada, United States of America, England and Germany (Jakab and Kumhof, 2015). Graham Towers (1939), the then governor of the central bank of Canada stated that:

> "Each and every time a bank makes a loan, new bank credit is created — new deposits — brand new money".

Alan Holmes (1969) who was the vice president of the New York Federal Reserve stated:

> "In the real world, banks extend credit, creating deposits in the process, and look for the reserves later." (Investopedia, 2019)

In England, the Bank of England employees, Berry, Harrison, Thomas and de Weymarn (2007) echoed the same by saying:

> "When banks make loans, they create additional deposits for those that have borrowed the money."

4. Money Creation by Islamic Banking Industry

The above paragraph presents the reality of bank's money creation by private commercial conventional banks. The context of this study is bank's money creation by the private commercial Islamic banks. The authors will proof, supported with literatures, that private Islamic commercial banks do involve with money creation the same way conventional commercial banks do.

Islamic commercial banks were established with the aim to avoid the practice of *riba, gharar* and *maysir* (Schoon, 2008; Derbel, Bouraoui & Dammak, 2011) that embedded in conventional commercial banks hence its operation must follow Shariah (Schoon, 2008; Derbel et al., 2011). Consequently, Islamic banks provide financing based on a profit and-loss-sharing concept (Ismail & Tohirin, 2010).

Despite the above, a number of Muslim researchers contended that Islamic banks operate on the same FRB system as conventional commercial banks do (Meera et al., 2009; Kureshi & Hayat, 2015). In Malaysia, the system refers to as Statutory Reserve Requirement (BNM, 2019). Hasan (2014), referring to the financing products offered by Islamic banks, argued that "all deferred payment contracts in Islamic finance involve credit creation."

5. How Do Banks Create Money?

Having established that Islamic banks do operate on FRB system that lead to money creation, the discussion is now focus on the process of money creation by private commercial banks, both conventional and Islamic banks.

All elementary economic textbooks will explain bank's money creation as the process of money creation by the banking industry as a whole. Parkin (2007), Vengedasalam & Madhavan (2013) and Borges (2016) explained the process of money creation by the banking industry as follows:

> <u>Step 1:</u>
> Assuming the legal cash requirement is 10%. (Banks keep 10% of deposits and lend 90% out). Suppose that a customer, Mr Arwin, deposits RM 1,000 in Public Bank, the Bank needs to keep RM 100 as reserve and RM 900 to be lent out.
>
> <u>Step 2</u>
> Next, Public Bank gives a loan of RM900 to another customer, Ms Catherine. She receives the loan and bank-in the same amount into her account at Maybank in the form of deposit (assuming that there are no leakages). Consequently, Maybank needs to keep RM 90 as reserve and lend out RM 810.
>
> <u>Step 3</u>
> Maybank gives a loan of RM810 to another customer, En Razak who deposits the RM810 into his account at the Southern Bank.

The process continues and the amount of money created by the banking industry is summarised in Diagram 1. The total amount of money created (in the form of deposit) by the banking industry can be calculated using the following formula (Vengedasalam & Madhavan, 2013):

RM1000 + RM900 + RM810 + RM 729 + RM ………

$$\text{Cash Ratio} = \frac{\text{Cash Reserve}}{\text{Initial Deposit}} \times 100\%$$

$$\text{Total Money/Credit Creation} = \frac{1}{\text{Cash ratio}} \times \text{Initial loan}$$

$$\text{Total Money/Credit Created} = 1/10\% \times \text{RM } 1000 = \text{RM } 10{,}000$$

In brief, from just a deposit of RM 1,000, commercial banking industry would be able to create RM 10,000 in the form of deposit and this amount contributes to the money supply statistic (Vengedasalam & Madhavan, 2013). Note also that the total amount of money created is also attributed to the legal reserve ratio. The smaller the reserve ratio, the more money can be created. The process of money creation involves the deposit by customers and loan/financing products offered by the banking industry.

The Process of Money Creation in the Banking System

First bank – Public Bank

Assets	**Liabilities**
RM100 Reserves RM900 Loans	RM1,000 Deposit

Second bank – Maybank

Assets	**Liabilities**
RM90 Reserves RM810 Loans	RM900 Deposit

Third bank – Southern Bank

Assets	**Liabilities**
RM81 Reserves RM729 Loans	RM810 Deposit

Diagram 1

The intensive study on FRB system and money creation has unravelled more insights on how banks create money. Werner (2014a, 2014b) and Arfah & Borges (2015) explained that the money banks disbursed to borrowers are non-funded money that banks created out of thin air operated by the allowed accounting entries.

6. Impact of Money Creation

As presented in the proceeding paragraph, bank's money creation has both positive and negative contribution to the banking and finance industry, the economy and the society. The proponents asserted that money creation, which most of them refers to Quantitative Easing, has savaged countries' budget deficit; and provided stability in financial systems (Swamy (2014).

LeLoup, Dietz, Hogye, Papai, Urban & Varadi (1998)'s study of Hungarian economy found that Hungary has not been living on deficit budgets as the deficits are primarily financed with foreign borrowing and by new money creation which has kept inflation above 20 percent annually. Ghosh & Mourmouras (2001)'s study on inflationary financing argued that even though money creation is inflationary, it still has positive impact on the growth. Azam & Emirullah (2014) supported both studies and concluded that money creation is used to finance country's budget deficit and at the same time it resulted persistent inflation. China's tight economy in 1979 and 1980 was savaged by bank money creation (Coplin & O'Leary, 1985). Swami (2014) examined factors that contribute to financial stability using vector auto regressive (VAR) model. He suggested that banking sector is vital for the stability of financial systems due to its money creation ability and warned unstable banking systems was associated with hyperinflations and depressions. All of the above studies that indicated the positive contribution of money creation focus on Central Bank's money creation. This particular study inquiries into money creation by individual private commercial banks.

As explain above, the money created with just a stroke of keyboard (Standard and Poor's, 2013) to fund the approved loan and financing by the individual private commercial conventional and Islamic banks every time they disbursed the loan and financing are counted as money supply in an economy. Every loan and financing approved by the banks will bring the "money" from non-existence into existence (Arfah & Borges, 2015) and will increase the supply of money in the economy (Vengedasalam & Madhavan, 2013). The exponential growth of money supply in the economy outpace the growth in the production of goods and services lead to a situation of too much money chasing too few goods and services. Consequently, the value of money is debased which means higher prices of goods and services and this scenario is translated into inflation in the economy (Rowbotham, 1998; Sudeley, 1999; Leithner, 2011). The value of hard-earned physical cash and coins owned by the normal people will diminish every time banks approve loan and financing (Meera et al., 2009). This bank's money creation-derived inflation causes the ordinary people's ability to own assets (houses, cars, etc) greatly weakened (Leithner, 2011; Positive Money, 2019). Consumers need to pay more for the same assets. If the amount of salary paid by the employers does not increase in proportion to the increase in money supply, consumers will end up unable to buy and own assets. Eventually people's purchasing power to own assets is transferred to the shareholders of the private banks or the small segment of the society (Meera & Larbani, 2007; Leithner, 2011). In the long run such scenario will result in inequality and unequal wealth distribution (Zarlenga, 2002; Brown, 2015; Murray, 2009; Meera et. al., 2009; Paul, 2013). The system has been operating for decades and accepted by the authorities. The society, being the consumer of the system, has to accept this system. Without them realising, the value of their hard-earned money is being decreased and taken away from them. Nobody will want their purchasing power being taken away and this is a form of theft (Rothbard, 2005). The secret is unknown to the mass and it is form of deceit by the banking industry (Rothbard, 2005). Hulsmann (2009) judge FRB system as fraudulent and akin to embezzlement and counterfeiting as the system is allowed by the law and operated by the banking industry. On the moral compass, the system is unethical and unjust (Hulsmann, 2009). From Islamic perspective, money creation mechanism enabled by the modern banking FRB system is a form of riba and contradicts with the *Maqasid al Shariah* (Meera et al., 2006, 2009, Sani, Arfah, Meera & Aziuddin, 2013; Al Twijri, 2016. Ismail (2019)'s analysis on the principle of *ar Rawaj*, an important element for achieving the principle of *Hifz al Mal* found that money creation violates such principle. In suggesting an alternative system to replace FRB system, Syamlan (2016) and Ahmad & Ismail (2017) argued that Full Reserve Banking system will eliminate the element of injustice and *riba* hence attaining the

Maqasid Shariah. Syamlan (2016) also concluded that FRB system has more *mafsadah* dan *maslahah*.

7. Shariah Compliancy by Islamic Banks

Shariah compliance is the core of Islamic finance and it is the most significant feature for any Islamic Banking and Financial institutions that differentiate themselves from their conventional counterparts (BNM, 2004; Hassan, Ariffin, Othman, Napiah, Omar, Yusoff, Zaharim., 2013; Kasri, 2015; Muda & Jalil, 2008). From another perspective, it is the very objective of Islamic Financial Institutions (IFIs) in all their operations, products and affairs. The introduction of Islamic Financial Services Act (IFSA) 2013 has brought up the subject of Shariah compliance in the Malaysian Islamic banking industry to the highest level. The preamble to IFSA 2013 clearly stated:

> *"An Act to provide for (i) the regulation and supervision of Islamic financial institutions, payment systems and other relevant entities and (ii) the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and* ***compliance with Shariah*** *and (iii) for related, consequential or incidental matters."*

In other words, IFSA 2013 has provided greater emphasis on Shariah compliance coupled with a comprehensive legal framework fully consistent with the Shariah in all aspects of regulation and supervision, from licensing to the winding-up of an institution (Miskam & Nasrul, 2013). Attaining Shariah compliance is a profound regulatory objective provided under IFSA 2013 (BNM, 2016). In other words, Shariah compliance is the actual objective of the Shariah governance mechanism and the Shariah audit function stipulated in IFSA 2013.

The scope of Shariah compliance is holistic and end-to-end, covering every aspect of IFIs. Section 28 (1) of IFSA 2013 states:

> *"An institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with Shariah."*

Shariah compliance of the Islamic banking system is highly emphasised by Bank Negara Malaysia (BNM) through IFSA 2013. IFSA 2013 statutorily enforces the realization of Shariah compliance for all Islamic Banking and Financial institutions in Malaysia. All operations, business affairs and activities of the IFIs must comply with the decisions made by the Shariah Advisory Council (SAC) of BNM and Shariah Committee (SC) of the respective IFIs. Previously, non-compliance with BNM's Shariah Governance Framework (SGF) would have subjected the IFIs concern to sanctions by BNM. With the IFSA 2013, breach of Shariah governance principles constitute criminal offences carrying heavy penalties (Shariff, 2015).

According to the Islamic Financial Services Act (IFSA) 2013, Islamic financial institutions are required at all time to assure and ensure their Shariah compliance status through the mechanism of Shariah Governance and Shariah Audit. Additionally, section 28 (3) of the Islamic Financial Services Act (IFSA) 2013 sets out clearly the obligations and responsibilities of a financial institution in the case of Shariah non-compliance, and the subsequent reporting and disclosure processes. Penalties and consequences of not following Shariah non-compliance reporting procedures can be severe.

8. *Syubhah* in Islam

Syubhah literally means "suspicious", "doubtful" and "skeptical". It is a condition or status between *halal* and *haram* where the determining factors of both are not clear or definite. A matter is considered as *syubhah* when it is viewed as Shariah-compliant from one perspective and considered as Shariah non-compliant from another. *Syubhah* arises out of two conflicting beliefs which come into clash with each other (Al-Ghazali, 1993). The Prophet Muhammad PBUH once said (Abū Dāwud, 2010; al-Bukhārī, 1999; Al-Ghazali, 1993; al-Tirmidhī; Muslim, 2006):

> *"Lawful things (halal) are clear, and unlawful things (haram) are also clear. However, there are doubtful matters (syubuhat) between both. Most of the people do not know them. He who saves himself from syubuhat purifies his honour and religion. He who falls in syubuhat may fall in unlawful matters like the shepherd who has got chance of falling into reserved grazing ground where he grazes his flock of sheep around it. …"*

According to al-Ghazali, *syubhah* could arise from four main causes. The first cause of *syubhah* appears in the course of *halal* and *haram* determination. Secondly, *syubhah* could arise from the mixture of *halal* and *haram*. Thirdly, *syubhah* could be caused by the sin occurred in the process of making a *halal* matter. Fourthly, *syubhah* could also arise out of diversity of the evidences of Shariah such as contradictory evidences, contradictory signs and contradictory assumptions (al-Ghazali, 1993).

An example of *syubhah* in Islamic finance could be the *bay' inah* practice. *Bay' inah* was widely applied in the Malaysian Islamic banking system in the early stage of its development. Although majority of Islamic jurist ruled that it is unlawful, the Shafi'ites view that *bay' inah* is permissible subject to certain conditions. Afterward, the practice of bay' inah in the Malaysian Islamic banking system was claimed to be not in line with the Shafi'ites' view of *bay' inah*. Nowadays, most of the Islamic banks in Malaysia have moved away from the practice of *bay' inah* due to its controversial position.

9. Analysis of Money Creation

Bank's money creation by private conventional commercial banks are clearly involve riba hence against the *Maqasid al Shariah* as all elements that not permitted by Shariah exist they loan products due to loan contract applied. Riba element exists when the borrowers have to pay more than the loan amount. The activities and offerings of conventional banks also involved in activities that not permitted by *Shariah*.

In the case of money creation by the Islamic commercial banking system, the *syubah* may arise due to the conflicting approaches in evaluating the Shariah compliance of Islamic banking system. In most of the cases, Shariah compliance of Islamic banking financing is viewed through contractual approach i.e. product compliant paradigm. As long as the pillars and conditions of the financing contracts are fulfilled by the contracting parties, i.e. Islamic bank and customer, they are considered as Shariah compliant. The economic implications of such financings on the money creation due to the FRB system, concentration of wealth by the private banking institutions, monetary inflation and other economic ills as discussed in the above (Section 6.0 Impact of Money Creation) are hardly to be examined and evaluated under the purview of Shariah compliance.

Based on authors' suggestion of Shariah compliance levels/categories, the implications of Islamic banking financing at the socio-economic level and the realization of Shariah objectives in finance and economy should be considered for Shariah compliance determination.

10. Conclusion and Recommendations

The issue of money creation by Islamic banking requires urgent attention by all especially the Shariah Advisors. The product compliance paradigm being practiced now may have to be expanded to include the implications of the financing i.e. socio-economic impact. As alternative banking models have been fully operationalised in U.S.A (Brown, 2015), the researchers call upon all relevant parties to examine the matter.

Islamic banking system should be Shariah compliant at all levels and stages, that include its implications of banking activities and operations, including it financing products, at the socio-economic level. Shariah compliance does not only concern the process of Islamic banking financing, but it also relates to the implications of the financing activities on the welfare of society at large. Based on the authors' analysis, as an interim measure, the researchers propose the following Shariah compliance framework for Islamic banks:

- Product concept and structure
- Business operations and practices
- Distribution of wealth and purification of income
- Socio-economic implications

The following Table 1 summarizes the scope of Shariah compliance for each category.

No.	Category/Level of Shariah Compliance	Explanation
1	Product concept and structure	At this level, the Shariah compliance scope may be restricted to the fulfilment of general and specific contract's conditions and avoidance of the prohibited elements. While many of the researchers insist on the prohibition of *riba*, *gharar* and *maysir*, Jalil,et al. (2014) have summarized the prohibited elements in Muamalat transactions into four main elements. They are: (i) riba (interest and usury), (ii) gharar (uncertainty), (iii) darar (harm), and (iv) intihak al-hurmah al-Sharʿiyyah (violation of Shariah sanctity)
2	Business operations and practices	This category of Shariah compliance should include consideration of the overall business operations and practices of the Islamic banks. This includes the documentations, marketing strategies and techniques (such brochures and TV and radio commercials – using the proper images and languages), employees' ethics, appearance and impression (such as apparels), IT systems, treatment of the customers and communication with all stakeholders, adherence

		to the relevant products or operational standards and guidelines issued by the institutions or governing bodies in business operations and etc. This level is highly significant as it relates very close to the products implementation. Even though the products concept and structure are Shariah compliant at the beginning, the risk of becoming non-compliant does still exist. If the underlying contracts and conditions are not carefully executed, the products may turn null and void.
3	Distribution of wealth and purification of income	In this category of Shariah compliance, the Islamic banks distribute their income to their shareholders, partners, customers and employees according to the contractual obligations between them. At the same time, Islamic banks have other several obligations such as payment of zakah and taxes, debts and so forth. Islamic banks may also purify and clean a portion of their revenue as Shariah non-compliant income.
4	Socio-economic implications	At this level, Shariah compliance framework should include the Islamic banks' extent of contribution to the realization of Shariah objectives especially in the area of economics and finance such as: - the IFI's contribution to the equitable distribution of wealth in the financial system; - the IFI's contribution to the just monetary system; - the IFI's contribution to the promotion of trust-based cooperative business schemes such as Mudarabah and Musharakah; - the IFI's contribution to the achievement of the sustainable growth such as environmental protection and green technology; and et cetera.

Table 1 Scope of Shariah Compliance

The subject of money creation by Islamic banks through its financings relates very much to the Shariah compliance at the level of socio-economic implications. The authors believe that Islamic banks should be Shariah compliant in their business operations, activities, affairs as well as socio-economic implications.

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