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Reflections on the Relationship Between Central Banks and Islamic Banks in the Context of a Traditional System

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Summary
The article addresses the relationship between central banks and Islamic banks within a traditional banking system, focusing on monetary policy tools and their direct impact on the performance of Islamic banks. The study concludes that the use of traditional tools by central banks, such as reserve ratios, liquidity ratios, and discount rates, imposes constraints that conflict with Islamic principles, creating significant challenges for these institutions. These challenges include legal issues, the freezing of investment account funds, declining profits, and restrictions on investment areas, leading to an unbalanced competitive position compared to traditional banks.
Keywords: Central Banks; Islamic Banks; Monetary Policy; Banking Challenges.

Introduction

1- Overview

The relationship between central banks and Islamic banks is fundamental to the global economies today. Monetary policy tools play a pivotal role in enhancing the performance of these banks. The nature of this relationship determines the extent to which these banks contribute to economic and social development, through various forms based on partnerships and sales. This system is grounded in profit and loss sharing, contrasting with the interest-based lending of conventional systems. This article aims to explore how the monetary policies adopted by central banks affect the operations of Islamic banks and the resulting challenges related to compliance with Islamic principles.

2- Main Issue

How do the monetary policies adopted by central banks influence the performance of Islamic banks? What challenges do these banks face within a traditional banking system?

3- Sub-questions

- What do we mean by a central bank, and what do we mean by Islamic banks?

- What are the conventional tools used by central banks, and how do they impact Islamic banks?
- What are the legal and economic challenges faced by Islamic banks as a result of these tools?

4- Importance of the Study

The significance of this article lies in presenting the importance of the relationship between central banks and Islamic banks, which helps in understanding the challenges and opportunities available. It emphasizes the necessity of enhancing cooperation between central banks and Islamic banks, contributing to sustainable development and economic growth.

First: What is a Central Bank?

1- Definition of a Central Bank

The central bank is defined as a part of the government that undertakes the management of the government's financial operations. Through managing these operations, it can influence the behavior of financial institutions to align with the state's economic policy. This definition focuses on the central bank's role as the government's bank. De Kock, however, defined central banks as those that regulate and determine the monetary and banking structure to achieve the greatest benefit for the national economy. This is accomplished through multiple functions, such as regulating currency and private finance, managing government operations, holding commercial and monetary reserves for banks, serving commercial banks by rediscounting commercial paper, and acting as a lender**.** (Fashar , 2016, p. 307)

2- Characteristics of the Central Bank (Fashar , 2016, p. 307)

- ✓ The central bank issues what is called legal tender, that is, converting real assets into monetary assets and vice versa. Legal tender originates from the central bank, which is authorized by the state to perform this process. Due to its monopoly on this privilege, it represents the lender of last resort, to which the government and other banks ultimately turn if they cannot find liquidity elsewhere. The process of issuing money falls within its comprehensive vision of the monetary situation and its future developments.
- ✓ The legal tender issued by the central bank differs from other types of money (deposit money). It is characterized by certain features, being generally accepted money with unlimited legal tender status and being completely liquid, unlike deposit money issued by commercial banks.
- ✓ There are no multiple, independent sources issuing money. Rather, there is a single central unit that oversees credit, with the possibility of having branches of the central bank to facilitate its tasks and be more precise and organized
- ✓ The central bank does not deal with individuals, as it is concerned with regulating and supervising the operations of commercial banks. Therefore, it cannot compete with them in their activities, especially since it is considered a

bank for these banks, holding the balances that are legally required of it, unlike other banks. Hence, if it were to compete with these banks, it would be exceeding its function.

✓ The objective of the central bank differs from that of commercial banks or private enterprises in terms of profit-making. It is generally accepted that the main objective of central bank policy, even in a capitalist economic system, is not to generate profits but to serve the general economic policy.

✓ The central bank has the legal authority to use certain means by which it can compel commercial banks to implement monetary policy

3- Definition of Islamic Banks: There are many definitions of an Islamic bank, but they have almost the same meaning, for example:

✓ It has also been defined as Islamic organizations working in the field of business with the aim of building and developing the Muslim individual and society and providing opportunities for the advancement of Islamic foundations committed to the application of the provisions of Islamic Sharia in all banking and investment transactions through the application of the concept of financial intermediation based on the principle of profit and loss sharing; (Haidar, 2012, p. 27)

✓ In the agreement establishing the International Union of Islamic Banks, Al-Jammeh defines that Islamic banks are those institutions whose establishment and articles of association are stipulated by law to abide by the principles of Sharia and not to deal with interest in giving and taking. (dakiche & Hawila, 2021, p. 444)

Second: The Central Bank's Supervisory Tools for Islamic Banks.

The central bank has supervisory tools that will be addressed as follows:

1-Discount Rate:

The discount rate refers to the interest charged by the central bank for rediscounting commercial papers on behalf of commercial banks that wish to obtain cash liquidity (Resources & Farajallah, 2019, p. 29). With this tool, the central bank can influence the credit volume—contraction or expansion—so raising the discount rate means restricting credit, while lowering it allows banks to expand credit. In inflationary times, the discount rate is raised to prevent commercial banks from rediscounting their commercial papers with the central bank or to reduce this behavior. Islamic banks do not deal with interest, either receiving or giving, and thus do not benefit from the discount rate. (Rahman & Cherfa, 2020, p. 167)

2- Legal Reserve Ratio:

This is a tool used by the central bank in most countries to influence the ability of commercial banks to create fiat money or deposit money, in addition to protecting depositors' funds. This tool does not align with investment accounts in Islamic banks, which are provided for investment based on profit and loss sharing. The bank is not obliged to guarantee the full return of these funds to their owners except in cases of misconduct or negligence, which is different from deposits in traditional banks that are considered debts that they guarantee. Therefore, the philosophy underlying this tool, which aims to protect depositors' funds, does not apply to Islamic banks but rather to traditional banks (Rahman & Cherfa, 2020, p. 168).

3- Open Market Operations:

This involves the buying and selling of government securities by the central bank in the market, with the primary goal of directly influencing the volume of deposits in commercial banks. The mechanism of this policy consists of the central bank purchasing government bonds held by commercial banks, paying cash for these bonds, which increases the available deposits in commercial banks. This means an increase in loans available for lending and thus an increase in the money supply. Conversely, when the central bank offers quantities of government bonds for sale to commercial banks, it receives cash in return, leading to a contraction in the volume of deposits in commercial banks and a subsequent decrease in their lending capacity, resulting in a decrease in the money supply. This policy is considered indirect, as the direct impact is on the volume of deposits, and open market operations affect the prices of securities, interest rates, and banks' investments and loans. The central bank's purchase of bonds may lead to an increase in their price, which lowers the interest rate due to the known inverse relationship. With an increase in deposits at banks, this encourages banks to lend, leading to an increase in the money supply, and the reverse occurs if the bank sells government bonds (Abd elhalim & abada , 2016, p. 07).

4- Liquidity Ratio:

This refers to the central bank forcing commercial banks to maintain a minimum liquidity ratio determined by certain assets relative to some liabilities. This means that commercial banks must freeze some of their assets in reserves to avoid excessive lending (Rahman & Cherfa, 2020, p. 168).

5- Moral Suasion:

The central bank uses moral persuasion or convincing techniques to encourage banking institutions to cooperate with it in implementing a specific monetary policy. This depends on the importance and extent of cooperation between the central bank and commercial banks . (Mokhtari & Ben Elba, 2021, p. 07)

6- Lender of Last Resort:

The central bank provides loans to banks in need to maintain monetary stability and the safety of the banking system and to protect depositors' funds during liquidity emergencies at interest rates it determines. It intervenes as a lender of last resort to prevent banks from reaching a state of financial distress by providing them with cash liquidity to meet customer withdrawal requests after ensuring that this financial distress is not due to mismanagement or corruption. As is well known, Islamic banks do not deal with interest, either receiving or giving, and therefore do not benefit from the central bank's role as a last resort for liquidity, which traditional banks benefit from. Thus, they are in greater need of a last resort that considers their specificities and nature of banking operations, providing them with loans on non-interest-based principles to continue their economic and social roles. (Rahman & Cherfa, 2020, p. 170)

7- Credit Ceiling Policy:

This is an organizational measure used by monetary authorities when the economy suffers from a high degree of inflation by setting ceilings on the growth of loans granted by commercial banks through direct administrative means, such that the distributed loans do not exceed a certain percentage over a specified period. The principle is to influence the primary source of money creation, which is granting loans by banks and financial institutions (nacer, 2004-2005, p. 79).

8- Minimum Subscription to Public Bonds:

Central banks in many countries require banks to continuously hold a certain volume of public bonds according to their obligations to others, usually representing a percentage of the total portfolio of the bank's securities. Consequently, banks cannot convert them into liquidity before maturity, ensuring a minimum contribution from the banking system to government financing and reducing banks' opportunities to dispose of these government bonds to increase loans for general commercial purposes. This is considered an additional tool for controlling bank liquidity (nacer, 2004-2005, p. 81).

Third Requirement - The Implications of Applying Traditional Supervisory Tools on Islamic Banks: (ichaal, 2020-2021, pp. 110-114)

1- Guaranteeing the Unguaranteed:

From its traditional perspective, the central bank aims, directly or indirectly, to protect depositors' funds. This is translated into several tools, including the mandatory reserve ratio, the liquidity ratio, and international supervisory standards that obligate banks to maintain sufficient liquidity and capital to guarantee depositors' rights, whether the bank is conventional or Islamic, and regardless of the nature of its accounts. In this context, investment account funds in Islamic banks are treated like other accounts in terms of guaranteeing the principal and returns. This has placed these banks before a Sharia-compliant challenge of guaranteeing the unguaranteed, otherwise the Mudarabah contract would turn into a guaranteed loan contract that generates interest.

2- Disabling the Funds of Investment Account Holders:

Islamic banks face challenges due to traditional regulatory tools, such as reserve ratios and liquidity ratios, which compel them to freeze a portion of investment account funds. This action is justified under the guise of protecting account holders' interests but contradicts the principles of Islamic banking. Imposing the same regulatory ratios forces these banks to violate Sharia principles, which prohibit hoarding investment funds and result in lost profit opportunities for account holders.

The Mudarabah contract requires that all funds be invested, and the bank's control over these funds is a trust. Keeping a significant portion outside the investment domain violates this contract. As investment banks, Islamic banks must retain a portion of account funds for investment purposes. The requirement to comply with traditional regulatory tools hampers their investment activities and prevents them from fulfilling their objectives and those of the account holders who expect their funds to be invested with associated risks and returns.

3- Decreased Bank Profits:

The fact that Islamic banks hold a portion of their accounts in non-returnable cash, whether due to compliance with traditional regulatory ratios based on available liquid assets or the absence of Sharia-compliant investment avenues such as Islamic money and financial markets and their instruments, will affect the Islamic bank's profitability. This is because potential investment opportunities are missed if all account funds were invested, negatively impacting the bank in two ways. First, it reduces the amount of returns distributed to account holders, as the Islamic bank will be paying returns on uninvested funds. Second, it negatively affects the bank's investment efficiency, as profit is tied to the amount of invested funds, while returns are tied to the size of investment accounts. This has negative repercussions on the Islamic bank's ability to mobilize financial resources in the future and its competitiveness.

4- Decreased Competitiveness:

As a result of the aforementioned challenges facing Islamic banks, in addition to regulatory tools that favor conventional banks at the expense of Islamic banks, Islamic banks have been placed in an unequal and unfair competition with their conventional counterparts, which operate within a system specifically designed to meet their needs. While conventional banks benefit from the advantages of dealing with assets determined by central banks, such as treasury bills and discounted commercial paper, whether in terms of compliance with required liquidity and reserve ratios or in terms of the diverse investment opportunities they provide and the fixed and guaranteed returns they generate, we find that Islamic banks exclude all these assets and investment opportunities from their transactions because they are based on interest, which prevents them from benefiting from the same advantages. This is what puts Islamic and conventional banks on the same competitive level

5- Restricting the scope of investment:

One of the most significant factors affecting Islamic banks, and a challenge hindering their achievement of investment objectives, is the restrictions imposed by central banks on investment sectors. These restrictions prohibit dealings in real estate and movable assets except in special cases. They also impose favorable conditions for investment in equity stakes in companies. Unlike conventional banks, the nature of

Islamic banks' activities requires them to own equity shares in companies and projects, which necessitates ownership of real estate or movable assets within the framework of such participation. Furthermore, the nature of sales transactions requires banks to deal in and possess real estate and movable assets; otherwise, they fall into the prohibited practice of "selling what they do not own." This negatively impacts the investment and developmental role pursued by Islamic banks and prevents them from properly implementing their transaction procedures.

6- Usurious transactions related to mandatory reserves and the system of penalties:

In their efforts to ensure that member banks comply with their supervisory instruments, central banks employ a system that varies between reward and punishment based on usurious interest. These methods involve granting an interest rate to banks in exchange for depositing a percentage of their account funds in the central bank's reserve account, and conversely, imposing an interest rate as a penalty on banks when they violate central bank instructions, such as a shortage in The mandatory reserve requirement or achieving a liquidity ratio lower than required, and the necessity of complying with the conventional regulatory system and Sharia controls that consider these interest rates to be explicit usury, present Islamic banks with a real challenge, whether they adhere to the imposed instruments or not.

Conclusion

In conclusion, it is evident that central banks play a fundamental role through monetary policy tools that directly impact the performance of Islamic banks. By utilizing traditional instruments such as reserve ratios, liquidity ratios, and discount rates, these banks impose constraints that may conflict with Islamic principles, creating significant challenges for these institutions within a conventional banking system.

These obstacles manifest in the freezing of investment account funds, declining profits, and restrictions on investment areas, leading to an unbalanced competitive position compared to traditional banks. Additionally, the limitations imposed on their investment activities, along with interest-related transactions associated with mandatory reserves, hinder their ability to achieve investment objectives and meet customer needs.

Therefore, there is an urgent need to develop regulatory tools that align with the nature and goals of Islamic banks. Central banks should strive to find innovative solutions that enable Islamic banks to operate efficiently, thereby enhancing their role in the economy and contributing to the stability of the financial system. Strengthening cooperation between central banks and Islamic banks will positively contribute to achieving sustainable development and enhancing economic growth.

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