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RELATION BETWEEN ISLAMIC BANK AND CENTRAL BANK*

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ABSTRACT

This study deals with the nature of Islamic banks and their features, and requirements of these features in terms of control tools and methods appropriate with the particularity of their business and their relation with the traditional central bank.At the same time aims to view the relationship between Islamic bank and central bank. To explain this relation the researcher started to explain what is the central bank, objectives of central bank, and characteristics, what is Islamic bank and objectives of Islamic bank. Then the researcher will speak about the relationship between Islamic bank and central bank from the side of how central bank's politics will impact in Islamic bank working.

Key Words: central bank, Islamic bank, relationship between Islamic bank and central bank

1. INTRODUCTION

The nature of relationship between Islamic banks and central banks differs from one country to another; it depends on the legal framework which regulates the status of Islamic bank within this countries. Some states have issued special legislation for conventional banking system.

Other states have had the initiative to develop and enforce legislations which would allow establishing Islamic banks in accordance with specific laws and regulations.

Yet there are three aspects of the central bank's relationship with Islamic banks:that are lender of last resort, a clearing house and,the central bank can manipulate the supply of money to the commercial banks and hence to the public, it can lend directly to banks to provide liquidity support directly to a bank that cannot obtain finance from other sources.

And more generally it oversees the financial sector in order to prevent crises, protect depositors, prevent wide-spread panic withdrawal, and thus to prevent the damage to economy that maybe cause by the collapse of banks.

While the central bank provides finance to conventional banks or by rediscounting commercial bill, which are prohibited in sahari'ah, it provides liquidity for Islamic banks on the basis of form of mudarabah or musharakah capital, the central bank would share in the profits from the Islamic bank's investment of the money over the period for which the fund are advanced .As clearing house, the central bank provides Islamic banks with facilities for the settlement of cheques and other payments and services around documentary letters of credit and guarantee in

return for a commission. The Islamic bank using the clearing system opens a current account with the central bank and limited short-term temporary over draft facilities exempted of interest are occasionally allowed to cover any temporary shortfalls for settlement purposes.

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The central bank may allow limited short term temporary facilities free of interest in the case of Islamic banks on the basis that these banks would place compensatory funds of the same amount for an equivalent duration, interest free with the central bank, or the basis of sharing in their profits for the period of the short fall. And as supervisor in regard to monetary policy, the central bank influence credit availability and inflation through money to provide a stable economic growth.

It should design patterns and forms of regular data required from Islamic banks to be developed and approved by central bank and Islamic bank representatives in order to comply with the nature of Islamic bank operations. Some central banks have set a lower level for the liquidity ratios within Islamic banks in comparison with their counter parts in other banks, taking into account the specific nature of their dealing.

However, there are some areas where different controls need to be done between Islamic and conventional banks depending whether they involve interest or not; these controls include statutory cash reserve requirements, liquidity ratios, deposit insurance schemes, credit ceilings, distribution of Islamic banks, profit, inspection of Islamic banks, profit equalization fund and monetary assets.

In fact, control of Islamic banks should take account of their specific characteristics; the statute of an Islamic bank must be approved by the central bank before the latter gives the bank permission to operate. Thus, control of the activities of an Islamic bank and examination of its processes should be conducted in accordance with its statute. Central bank should have a distinctive set of guidelines for the inspection of Islamic banks as well as regulations to safe guard Islamic investors' interests.

The central bank may also evaluate the investment programs of Islamic banks. For example, in cases where central banks pay interest on cash reserves, the ratio of reserves required from Islamic banks could be reduced on the grounds that they are not demanding any interest. Also a special consideration should be applied by central banks when applying credit ceilings to Islamic banks. Also, the minimum interest rates prescribed to commercial banks to pay on savings and time deposits should be replaced in the case Islamic banks by a weightage system to be given to these deposits for the purpose of profit distribution by the banks. (www.financialislamic.com).

2. ISLAMIC BANK

2.1. Definition of Islamic Bank

An Islamic bank may be defined as a financial intermediary whose objectives and operations as well as principles and practices must conform to the principles of Islamic law sharia, and consequently, is conditioned to operate all it activities without interest (Alam,2001).the aim of Islamic economics, as observed by (Molla et, 1998), is not only the elimination of interest based transactions but also the establishment of a just and balanced social order free from all kinds of exploitation.an Islamic bank is not only a financier but also a partner in business .the system essentially involves sharing of risk between the owner of capital and the entrepreneurs, as well as sharing the result of the collective efforts. Thus, it differs from an interest based system in which the risk is mainly borne by the entrepreneur or by the user capital. In other way we can call Islamic banking as participatory banking.

“Islamic banks are the cornerstones of the Islamic financial system and were the first financial institutions established under sharia principles” (Faleel Jamaldeen, 2012, p.56).

The very basic difference between conventional bank and Islamic bank is this: Islamic banks are based on interest-free operations.(Faleel Jamaldeen, 2012, p.56).

2.2. Permanent Sources of Islamic Bank

1-Permanent sources of funds –internal:
Accumulated Profits (Retained Earnings)
► Capital Reserves

► Revenue Reserves
2-permenant sources of funds –external:
Bank Accounts:
► Non-Profit Accounts or Current Accounts (Demand Deposits) Qard-e-Hassanah Deposits
► Profit Bearing (on Mudarabah basis)
Savings Accounts
Investments Accounts
External Qard-Hassan Deposits
►Like current account in conventional banks.
► Kept for safekeeping and convenience in payments (transfers)
► No return or profit offered
► Checkable
► Face value guaranteed by the ban
3-Permanent sources –profit bearing:
Savings Accounts
► Checkable just like conventional saving accounts
► the term to maturity is not fixed as in the case of term or fixed deposits
► can be assigned by the depositor to participate in productive activities, thus becoming PLS accounts (Mudarabah-based)
Investments Accounts:
► Investor committed for a certain time period
►usually not checkable.
►early withdrawal may be denied by the bank, but usually allowed as per the norms.
► usually there is a minimum period before which the withdrawal would result in denial of all profits.
► for the withdrawals made after the minimum period, the weightage is reduced accordingly.

2.3. Temporary Sources of Funds (Liquidity Management)

1-Special Mudarabah Portfolio:
► Islamic alternative to overnight lending and borrowing
►A separate portfolio is created by several banks jointly
Securitization:
► Islamic banks can securitize their assets (like real estate, Ijarah assets etc.) and raise the required funds
2-Salam:
► Islamic bank enters a contract with another financial institution agreeing to provide specified commodity to that institution in future and get the money now.
3-Tawarruq:
► Islamic bank purchases marketable (real) assets from the Financial Institution and sells it in the market to get funds
4-Back-to-back financing:
►If the bank has tight liquidity position it can direct the financing of a specific transaction to another bank.

2.4. Fee-Based Operations

1-Islamic banks can charge fee for providing following services:
► Checking account
► Money transfers
► L/C (Non-funded)
► Lockers (safe-keeping)
►Online services

► Debit Card and ATM services
► Collections
► Investment banking services
► Cash and Portfolio management advice
► Brokerage services
Letter of Guarantee.
Fee for issuing Letter of Guarantee disallowed
► But the bank has the right to be reimbursed for expenses incurred in providing the Letter of Guarantee.
►The amount charged should be uniform if the expenses incurred are same across various guarantees provided.

2.5. Activities of Islamic Banks

Individual banks differ in their application. These differences are due to several reasons including the laws of the country, objectives of the different banks, individual bank's circumstances and experiences, the need to interact with other interest-based banks, etc. In the following, we will describe the salient features common to all banks.

All the Islamic banks have three kinds of deposit accounts: current, savings and investment.

-Current accounts:Current or demand deposit accounts are virtually the same as in all conventional banks. Deposit is guaranteed.

-Savings accounts:Savings deposit accounts operate in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount back from the bank. Banks adopt several methods of inducing their clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Capital is not guaranteed but the banks take care to invest money from such accounts in relatively risk-free short-term projects. As such lower profit rates are expected and that too only on a portion of the average minimum balance on the ground that a high level of reserves needs to be kept at all times to meet withdrawal demands.

-Investment account:Investment deposits are accepted for a fixed or unlimited period of time and the investors agree in advance to share the profit (or loss) in a given proportion with the bank. Capital is not guaranteed(http://www.financialislam.com , 2014).

3. THE CONDITIONS IN ISLAMIC BANK REGULATION AND CONTROL OF CENTRAL BANK

Central banks subject Islamic banks to the same controls, conditions and regulation that they apply to the interest based banks. However, there are certain factors, which require that Islamic banks should be treated on a different footing.

Some of these factors are the following:

-Islamic banks like all other commercial banks are required to keep some of their deposits with central banks. Central banks usually pay interest on those deposits which Islamic bank cannot accept because of the most important characteristic of Islamic banks from conventional. Commercial bank, that Islamic bank doesn't deal with the rate buying or selling because dealing with the interest forbidden. An alternative is needed to ensure that Islamic banks get a fair return on their deposits with the central bank.

-Central banks function as lenders of last resort to commercial banks providing loans at times of liquidity crunch. Although most of Islamic banks function under the supervision of central bank, they cannot legitimately benefit from such a facility because such funds are usually provided on the basis of interest. His understandable that such assistance cannot be free for cost. However, there is a need to devise and implement on interest free formwork for such assistance.

-Legal reserves imposed on deposits with conventional banks are meant to meet possible withdrawals, whose rates vary between demand, saving and time deposits. This may apply to the same extent only in case of Islamic banks' demand deposits.However, the mudarabah a deposits are like bank equity.Therefore, Islamic banks should not be required to maintain reserves against them just as equity capital is not subject to those reserves.

-In countries where the central bank conducts open market operations, Islamic banks are not able to participate in these operations because of interested based nature of the securities bought and sold. Thus, Islamic banks are constrained by the fact that financial assets that could be liquidated quickly are not available to them. This introduces some rigidity in the asset structure of Islamic banks.

-Lack of understanding of the correct nature of Islamic financing techniques may also be partially responsible for rather in appropriate polices of the central banks towards Islamic banks. This is particularly true of musharakah and mudarabah. In debt financing, granting a loon by a bank is a onetime activity, no matter what is the size of the loons. Nut musharakah and mudarabah are ongoing activities and participation of an Islamic bank in these activities countries as long as the project financed is in operation. This may have important implications for reporting as well as control and regulation of Islamic banks by the central banks.

-Central bank regulators are sometimes unclear about the exact role of Shariah boards. It is sometimes felt that these boards may interfere in the banks' decisions with regard to monetary policy tools such as reserve requirements, open market operation, etc. it would be desirable to determine the exact role of the Shariah boards and take the central bankers into confidence (Iqbal, Ahmad, Khan, p. 37, 1998).

4. TOOL AND METHODS OF TRADITIONAL COTROL AND PARTICULARITY OF THE ISLAMIC BANKING WORK

The need for the regulation of relation between the central bank and the Islamic bank is a mutual need, the Islamic bank needs the assistance of the central bank if it lacks liquidity, and it needs the trust of the public which can only be secured when everybody knows that the central bank will assist the Islamic bank during its crises through the control and its subjection to different control tools, moreover the central bank cannot deny the existence of the Islamic bank since it is keen to control all banks and financial institutions operating in the banking sector under its supervision (Mira, 2011). Hereunder are the control tools applied by the central bank on the traditional banks, and the extent of their appropriateness to be applied on the Islamic banks, and the available alternatives in case of their non- appropriateness.

4.1. Discount Rate and Particularity of the Islamic Banks

The discount rate, or the so called rediscount rate, is like the interest rate earned by the central bank from the commercial banks against its rediscount of the promissory notes and bills submitted to it, the central bank obtains a discount rate when presenting guaranteed loans to the commercial banks (Hassan,1990). The discount rate provides the possibility of real opportunities to the traditional banks to obtain loans from the central bank, in particular when these banks face unexpected loss in reserves or an increase in a sudden market of credit or the inability to obtain the required liquidity in the money market (Eshamri, 1999).

On the other hand, the central bank controls the interest rate, by increase or decrease, according to different economic circumstances in order to effect the available credit volume, so if there are signs of inflation, the central bank raises the interest rate to increase the cost of loans on the commercial banks and its clients, and hence limit the credit volume and reduces the available payments means in economy, however if here are signs of deflation the central bank will reduce the interest rate to encourage the loans, and hence increasing the payment means (Alhurani, 1999). In view of the discount rate policy we find that Islamic banks cannot benefit from it, since this policy contradicts with its principle of work based on non-dealing with usury interests.

However the central bank can adopt, instead of the discount rate policy, a formula which can be appropriate with the rules of work of the Islamic bank such as a special contractual agreement between the central bank and the Islamic bank setting out the non-dealing with interest on the discount, i.e. the central bank earns an interest against the discount on negotiable instruments, and the Islamic bank deposits at the central bank an amount even if small but without interest. And if the central bank receives these instruments he makes them as a guarantee for loans granted to the Islamic bank without counting the interest upon their transfer to liquidity, or is returned by the Islamic bank in the manner of venture or participation or murabaha after transferring it to money, therefore the central bank shall rely on the system of participation in profits and losses instead of the system of interest, so that it can support the activity of Islamic banks and assist them in attaining their goals(Malak, 2000).

The central bank can fix the minimum and maximum limits of the interest rate through fixing the minimum and maximum limit of profits and losses, and therefore it subjects to all forms of loans, deposits and drafts accorded to the Islamic banks to the mechanism of investment work which in turns is subject to profit or loss, and this can determine the form of participation of the central bank in the framework of the Sharia formula in a way similar to the effect caused by the change in the interest rate, the central bank adopts the policy of changing the rate of participation in profits for the accorded financing, in line with its objectives aiming to control the credit and regulate the demand on the bank financing in general. When the central bank aims to extend the cover of credit, its participation will be limited to achieving a lower profit margin, and conversely in increases the profit margin, and accordingly the net margin of profit achieved by the Islamic bank is affected and hence contributing in controlling its financing and the domain of its participation in making the desired credit.

4.2. Operations of the Open Market and Particularity of Islamic Banks

These operations are summarized in that the central bank sells and buys negotiable instruments in the money market, in order to minimize the credit volume provided by the commercial banks by competing with them, and also to make a pressure on the liquidity of individuals if they sell negotiable instruments, this policy includes the dealing in foreign currencies and gold. In case of deflation, the central bank buys negotiable instruments in order to increase the liquidity in economy, and in case of inflation it sells the negotiable instruments in order to reduce liquidity (Alhindi, 1989). The dealing with negotiable instruments, such as government bonds, is deemed in contradiction with the rules of Islamic Sharia since these bonds represent a form of a loan contract, and they bear a fixed interests from their nominal value, and hence they are transformed to a form of usury loans which in their nature are contradicting with the nature of Islamic bank work.

Amongst the alternatives presented in the treatment of the difference of dealing with instruments, the central bank issues different negotiable instruments based on the principle of participation in profits and losses, which are in the form of coupons bearing variable rates of profits instead of instruments bearing fixed usury revenue, and by this mechanism the central bank can achieve its monetary goals and controls the volume of monetary offer as per these objectives, in case of its policy aiming to reduce the monetary offer, the central bank shall fix rates of profits less than the selling of coupons, and its participation will be lesser and with greater ability to absorb the savings and hence reduce the monetary offer, and in case of purchase it can fix the rate of profit higher through greater participation and hence extending and increasing the volume of monetary offer and achieving larger domains of credits(Aljamal,2003).

4.3. Legal Cash Reserve and the Particularity of Islamic Banks

The central banks' policy in countries with different affiliate banks are bound with the necessity to keep with them certain percentage from the total value of deposits at each bank as a cash balance in a special account kept at the central bank, this percentage changes from a country to another, and generally it ranges from (10% to 25%) from the total value of different deposits at each bank, by the use of the reserve the central bank aims to control the volume of credits which can be given by these banks, and therefore effecting the ability of money crearion (Alhurani, 1999, p.125).

This tool is not in conformity with the nature of funds at the Islamic banks since they are different from traditional banks, since the funds were provided to the Islamic banks for the purposes of investment on the basis of venture for example, and this means the sharing of responsibility between the bank and the funds owner according to the effective outcomes of the investment, and hence there is no obligation on the Islamic bank to warrant the reimbursement of these funds in full to their owners except what concerns trespass and negligence, and this is different from the deposits in traditional banks which are deemed debts in the liability of the bank.

Furthermore, the ability of the Islamic banks to create cash and increase the cash offer is very limited if compared with the state of financing with loans at the traditional banks, since the employment of funds at the Islamic banks is found in real investments (Irshid, 2007). Accordingly, it appears that the policy of legal cash reserve contradicts with the sound employment of funds in full, and its affects negatively the investment power, and the revenue distributed on the owners of investment accounts, since they hinder a part from these accounts without investment, however despite this tool is not in conformity with the philosophy and nature of the Islamic banking work however it favors the traditional banks. Therefore, it is necessary to adapt the obligatory reserve to be in harmony with the particularities of the Islamic banking work, and the main concepts in this field are as follows:

-the central bank shall exempt the investment deposits at the Islamic bank from the accounts of reserve restrictions since these deposits are provided by depositors to the Islamic bank on the basis of venture according to the effective outcomes of investment, such as profits and losses, and hence there is no obligation on the Islamic bank regarding the necessity to reimburse them in full since they are not guaranteed at the banks as is the case for the term deposits at the traditional banks, moreover the policy of legal reserve leads to the hindering of a part from the resources of Islamic bank regardless of the desire of the depositors and contradicts with the sound employment of funds in full, and this affects negatively the revenue distributed on the holders of the investment accounts (Dwaba ,2005,p.17).

-the non-application of the penalty interest rate on the Islamic bank in case of non-fulfilling the minimum limit of the legal reserve requirements, and its replacement by a system of fines related with the volume of default, in harmony with the reality of Islamic banking work which is safe from usury (Dwaba, 2006,p.17).The central banks' policy in countries with different affiliate banks are bound with the necessity to keep with them certain percentage from the total value of deposits at each bank as a cash balance in a special account kept at the central bank, this percentage changes from a country to another, and generally it ranges from (10% to 25%) from the total value of different deposits at each bank, by the use of the reserve the central bank aims to control the volume of credits which can be given by these banks, and therefore effecting the ability of money crearion (Yasser Alhurani, p.125).

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4.4. Cash Liquidity and the Particularity of the Islamic Banks

Among the procedures carried out by the central banks in order to regulate the liquidity and protect the funds of depositors as a guarantee for their reimbursement, they impose a rate of liquidity determined by the central banks from the total balances of the depositors at a commercial bank, the bank will keep the balances corresponding to this percentage in the form of liquidity in its treasuries or at the central bank, provided that these elements are kept from assets with high liquidity to facilitate their transfer to cash in case of increase in the movement of drafts by depositors above he expected percentage, some of these elements are debentures and promissory notes yielding revenue to the traditional banks, on the other hand we notice that Islamic banks do not deal with such manner, and hence in order to keep the prescribed liquidity rate these banks shall keep larger quantities of liquidity which do not yield any revenue(Yasser Alhurani, “Evaluation of the functional relation disruption sides between the central bank and the Islamic bank”, previous reference, p.113). The rate of liquidity prescribed by the central banks are usually around (20% to 25%) from the total deposits (Ahmed, 1993).

The implementation of the cash liquidity policy on the Islamic banks obliges them to keep large rate from the investment clients’ deposits in the form of liquid assets, and hence reducing the investment power of such deposits, and minimizing their profitability. Therefore treating the Islamic banks and traditional banks equally regarding the imposition of this rate makes the Islamic banks in a non-competitive and unfair position preventing them from investing inoperative funds, since the doctrine rule relied upon by the Islamic banks is the rule “if you benefit from a deal you have to pay for its expenses” and this in turn makes the Islamic banks unbound to warrant the funds of investors and they are partners in profits and losses.

4.5. Credits Caps and the Particularity of the Islamic Banks

The credits caps consist in regulatory procedures by which the central banks fix the maximum limit of the loans portfolio which may not be exceeded by the commercial banks, by a direct administrative manner according to rates fixed during the year, this is done in order to limit the expansion in total financing or keeping it at a secured level for cash expansion and the required financing, and also the distribution of loans towards sectors deemed more vital for development or requiring large financial resources, i.e. warranting a purposive distribution of the banks' investments and allocating funds in investments fields which achieve economic welfare through a plan drawn up by the state in determining the priorities and objectives of the society(Dwaba, p.15).

Regarding the extent of appropriateness of this control criterion for implementation on the Islamic banks, it is preferred not to use it since its implementation can lead to negative impacts harming the depositors and shareholders, knowing that the nature of works of the Islamic banks differ from the methods of credits granting at the commercial banks, the formulae of Islamic financing such as Murabaha and Istisnaa and Muzaraa are based mainly on the use of commodities, i.e. financing operations for the production of commodities, directly or indirectly, in other words, the cash flows resulting from these formulae are related with the commodities flows more than those resulting from credits granting process at the traditional banks, and hence the expansion in Islamic financing has relatively low impact as compared with the impacts of traditional financing related with inflation(Almabruk ,2007).

4.6. Prohibition to Deal With Movable and İmmovable Assets and the Particularity of the Islamic Banks

The central banks prohibit from the commercial banks to own immovable or movable assets except to the extent needed by the banks in terms of real estates and movable assets allocated to the management of the bank businesses. This restriction is in conformity with the nature of the traditional banks which rely on the third parties' funds as a commodity for trading, and this matter contradicts with the features which distinguish the Islamic banks from the traditional banks (Sowan, p.238).

The nature of investment in Islamic financing is based on the fact that money is a means of investment in productive, service and industrial operations, and therefore the Islamic system is characterized by the ownership of assets, whether immovable or movable, given that it is participant and not a financial mediator like its traditional counterparts.

4.7. Policy of the Last Lender and the Particularity of the Islamic Banks

Central bank is deemed the last recourse for the commercial banks, and if they need liquidity they recourse to it and take what they need against interest, however for the Islamic bank we cannot support its positions in the field of liquidity and credit by benefiting from granted loans due to their relation with usury discount rate (Irshid, p.318). To avoid such difference in the relation of the central bank with the Islamic bank there are many methods, mainly (Shebir, 1999).

- ✓ The contribution of the Islamic banks and financial institutions by a defined rate of their deposits at the central bank, and this contribution will form one bank deposit accorded by the central bank to any Islamic bank facing real risks and problems.
- ✓ The central bank shall adopt the method of participation in profits and losses, and in the implementation of this mechanism it shall adopt the application of preferential participation rate for the sectors with priority instead of preferential discount rates.
- ✓ Make a world or central Islamic bank playing the role of the last lender according to the rules of the Islamic Sharia through the membership of the Islamic banks wherever they exist, and regardless of the privileges of the one region.

5. CONCLUSION

The systems, tools and methods adopted by the central banks are largely inconsistent with the nature and philosophy of work of the Islamic banks, since the central bank has built its methodology of control and dealing on the basis of the nature of work of traditional banks and hence these methods and tools are consistent with their methodology despite the methods and nature of work of the

Islamic banks, therefore the method and basis of dealing by the central bank with the Islamic bank shall be different in order to be appropriate with their work nature (Abdalla, Aziz and Johari, p. 17).

There is an impact of the central bank polices on the emirates Islamic bank performance. The central bank oversight of deposits and credit in Islamic banks and use the same tools and methods used in the control of conventional banks.

At the end of this research we would like to present a group of recommendations the Islamic banks would like the central bank to take in to consideration to put for word new policies that will help the Islamic banks to improve its conditions: Adopting the obligatory reserve ratio regarding current deposits for the Islamic banks like the traditional banks while those related to the Investment accounts it must be Decreased because the Islamic bank doesn't guarantee its Deposits and Putting forward a plan for calculating liquidity ratio in away suiting the Deposits and assets dealt with by Islamic banks.Taking into consideration any alternative standards and Instruments regarding the creditor role according to Islamic laws principles and providing the necessary facilities as good loans when necessary so if the liquidity position still a problem or there is a surplus the Islamic bank will provide it as a good Debt for the central bank as it is and for the sure penciled too.

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