INVESTIGATING THE EFFECTS OF ISLAMIC DEBT PRODUCTS ON SOCIO-ECONOMY

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Abstract

The purpose of this paper is to examine the effect of hilah products-inflation relationship and their way-out to pursue higher socio-economic growth. Using Islamic principles and reasoning, the study is conducted within the ambit of two sacred sources, the Quran and Sunnah (recorded sayings and tradition of the Prophet), the reasoning principles in Usul Fiqh, Islamic legal maxims as well as a concept of banking system. The finding of the research is that the current hilah-based products do not really contribute positive socio-economic growth, instead inflationary pressure and transferring of wealth from a group to another group of people continue to exist in the economy. Hence, the products do not guarantee the upholding the five objectives of shariah. The researcher suggests that the reserve requirement must then be converted to a full reserve banking system that guarantees the full deposits of depositors in banking, with Islamic financing activities channelled more towards investment. The activities of Islamic bank do not necessarily have to be parallel with what is the norm in the conventional system. Instead the system has to be abandoned from hilah-based debt to equity, since the equity system is proven to be welfare-promoting to national and socio-economic interest, and to be immune from any financial crisis and economic disorder. The successful socio-economic growth cannot be built upon the hilah-based products and it needs to be transformed to make sure the socio-economy and the objectives of shariah guaranteed. This paper is perhaps one of the first to address on the Islamic debt products-inflation relationship, their consequences and the way-out by referring to two different methodologies; sources of shariah and banking system.

Keywords: Hilah-based products; fractional reserve; inflation; maqasid al-shariah; equity

Introduction

Islamic banking and finance are nowadays moving towards becoming the main stream of the financing system rather than the conventional competitor in a number of countries, in particular, countries that are dominated by Muslim residents. As the conventional system has been established ever since, followed by the Islamic system few years ago, has been well received in particular Islamic debt-based products which have provided easy availability of funds demanded by people. Banking and financing practices in Islam are subject to the guidance of Allah the Almighty in safeguarding socio-economic fields in all areas of human activity as one to fulfill the objectives of shariah (maqasid al-shariah).

As it is seen there is a need for shariah-compliant activities, the dynamic changes have occurred in the banking system today, in the sense of the development of Islamic debt-based financing products, to provide an alternative financial mode that is based on the conventional models and which is in accordance to the comments by El-Gamal (2006): “Islamic finance as
practiced today serves a primary goal of replicating conventional financial products and services, as efficiently as possible, utilizing classical contract forms (such as sales and leases). Various contracts might be used by bankers and financial practitioners, but the most common contracts used in banking and financing today are then based on the concept of so-called Islamic devices or hilah-based debts (Hatta et al., 2014). The ruling on that law of contract is mainly derived from the classical legal opinions of particular schools of law in Islamic jurisprudence.

Today, however, problems may arise when people have seen economic disorder and destruction that are likely to have originated from the misinterpretation of Islamic legal perspectives in that financial system, as Aggarwal and Yousef (2000) observe the opinions of two eminent Muslim scholars and economists, Siddiqi and Khan, ostensibly, ‘legally, the fear is that mark-up financing may open a ‘back door’ to interest. Observers (Siddiqi and Khan) worry that mark-up financing may stunt economic growth by constraining entrepreneurs from investing in new projects’. The statement made by these influential scholars expresses the notion that there are, perhaps, defects and flaws in the current practices of Islamic banking and financing products, even if their size and scope has been greatly increasing recently. Khan (1995) emphasizes that the excessive use of debts, credits and loans are unanimously seen amongst Muslim scholars as not fulfilling the purposes of shariah; for socio-economic prosperity and sustainability. If the entire system is then based on ideal Islamic principles, debt based financing would not be a mode of financing that is believed to promote socio-economic growth (Usmani, 2005).

As Islamic bank being heavily involved in providing varieties of debts mainly based on buy-back sale (bay‘ al-`inah) containing hilah element through the fractional reserve system, it is not a solution to financial and economic meltdown, particularly the inflationary pressure (Hatta et al., 2014). Hence, there is a pressing needs to examine the consequences of the existing products and to propose the critical alternatives that would fulfil the needs of markets and at the same time meeting the requirement of the shariah. Based on these grounds, the current study is conducted to address the following research question: How does the debt-inflation relation impact the socio-economy? How does the ideal Islamic mode satisfy the positive socio-economic interest as it is the one of the objectives of shariah? The next section addresses the relevant methodology to the research topic, which has measured the issue to be researched.

**Methodology**

Discussion of debt-based financial system from the perspective of the shariah law would require the use of the shariah principles, mainly of the Quran and sunnah (Prophetic traditions), and the rest of Islamic jurisprudence principles, interalia, maqasid al-shariah (objectives of shariah), maslahah (public interest), and its general principles namely al-qawaid al-fiqhiyyah (Islamic legal maxims) as supporting tools. In addition to that, the research also applies the concept of riba (interest), and fractional reserve banking system to get clearer picture of the debt-based and money supply system.

Maqasid al-shariah (objectives of shariah) is, according to Al-Ghazali (1971), divided into two types; dini (objectives of the hereafter) and dunyawi (objectives pertaining to the world). Each of these is divisible into tahsil (securing of the interest) and ibqa’ (preservation of interest). Tahsil is the securing of benefit and ibqa’ is the repelling of harm. The phrase ri‘ayah al-maqasid (preservation of the maqasid) is used to indicate both tahsil and ibqa’. The worldly objectives are further divided into four types; the protection of nafs (life), nasl (progeny), ‘aql (intellect) and mal (wealth). Each worldly objective is meant to serve the single dini (protection of religion). When all types are taken together, we have five ultimate
objectives of the law; protection of religion, life, progeny, intellect and wealth. These five objectives are designated as *darurah* (necessities). These are followed by the *hajat* (needs), which are additional objectives required by the primary objectives even though the primary objectives would not be lost without them. The third category is that of objectives that seek to establish ease and facility (*tawassu’* and *taysir*) in the law; these are called the *tahsiniyyat* (complementary values) (Nyazee, 2000).

Source: Meera & Larbani, 2006

Nyazee (2000) and Kamali (2003) have quoted a number of *maslahah* definitions given by different scholars by which it is concluded as a consideration of public interest that would fit the objectives of the Lawgiver, securing benefits and preventing harm; the texts, the Quran and *Sunnah* have never mentioned as to its validity or otherwise. Whereas *al-qawaid al-fiqhiyyah* (Islamic legal maxims) according to Mustafa al-Zarqa as translated by Laldin is the ‘general fiqh principles which are presented in a simple format consisting of the general rules of *shariah* in a particular field related to it’ (Laldin, 2006; Ismail & Rahman, 2013). The majority of these general principles of *fiqh* consist of a few words but at the same time would be able to cover the comprehensive meanings that can be applied to various issues of *fiqh*.

Each bank (including Islamic banks) can issue money, in the form of bank money or credit. Normally, banks issue credit against deposits. Islamic banks do issue credit via their debt-based financing products in association with the Fractional Reserve Banking System. Fractional Reserve Banking is a banking system where the banks (including Islamic banks) keep a required minimum reserve asset ratio, in order to secure sufficient liquidity to satisfy the depositors’ cash demand (Pass et al., 1988). In the Malaysian banking system they actually use a different terminology, the so-called Statutory Reserve Requirement (SRR) with the same function and objective as the Fractional Reserve Banking System (Hatta et al., 2014).

**Findings and Discussion**

This paper contributes to the existing body of knowledge in terms of narrowing the research gap by examining the consequence use of Islamic debt products towards inflationary pressure, and its alternative towards becoming better economic system for all. The novelty of this study is that it provides a holistic perspective of the critical view from *shariah* perspective and at the same time the economic discussion.
Islamic debt-inflation Relation and the Consequence

Perhaps the importance of debt is that it gives borrowers and lenders, either applying benevolent loan or sale-based credit means, opportunities to gain current and forthcoming benefits respectively. The borrowers benefit from loan or credit by more easily gaining wealth and owning properties. Whereas the lenders obtain profits from the proceeds paid to them by the borrowers. At almost all times there will be a group of people who are in need of wealth or capital but are unable to fulfill this immediately although they may be able to in the future. And there is a group of people whose wealth is in excess that are looking for profit in the future. Thus both groups exchange their interest through the Islamic debt-based financing products.

Likewise, Islamic debt is also important to link local business with international trade and commerce. It offers sustainability in the economic growth, at both the macroeconomic and microeconomic level. Local businesses and consumers have space and opportunity to manage their proper payment, without being depressed and troubled by paying in cash and at one time. They are free to fulfill the pre-determined pricing by installment basis and the bulk of payment can be split and evenly spread throughout the pay-off period. It is perhaps a form of proper planning towards the betterment of the economy (Suwailim, 2009).

Such a debt market would be fully segmented; there is no room for sudden and mass movements of funds. As regards these forms of debts which are borne to fulfil the domestic needs and necessities of life, shariah has entirely supported the importance of these debts (Qureshi, 2003). Therefore of the Islamic banking system as it presently operates and the products offered nowadays, Yakcop (1993) emphasizes: ‘there was no doubt in the minds of the authorities as well as the Malaysian public, that Islamic banking was indeed a viable proposition and was here to stay’. Perhaps based on the argument that this system is considered as having exercised the public interest and benefits (maslakah) for two parties, borrowers and lenders, sellers and purchasers from which it is regarded as realizing the objectives of shariah, justice and fairness in distribution of wealth.

Although such a product theoretically provides credit facilities to customers, buyers and borrowers and could be indirectly perceived exercising just distribution of wealth to all groups of people, but from another perspective it has been expanding the gap between the well-off (the corporate sector) and poor people (small industrial sector). When this hilah-based debt product is rampantly practiced through the fractional reserve system, inflationary pressure is inevitably going to drive the wealthy and corporate sector be dominant and get richer, whereas the poor would be poorer and small sector would find hard opportunity to survive. It could be translated into the transferring of wealth from one party to another, from the poor and small industries to the rich and to the corporate sector.

Transferring wealth means shifting of asset ownership through the hilah-based debt by financial institutions. Hilah-based debt, as referred to in the views of El Diwany et al. (2010)[1] and Siddiqi (2007)[2], are the causal factors of the inflation problem triggering off imbalances in wealth distribution, where one party is gaining and the rest is losing. This happens when they play a major role in all banking systems in the world, including Islamic banking that through the fractional reserve system. It is opposite to a view and theory that has claimed that today’s Islamic debt-based financing has guaranteed all people, in particular the Muslim clientele irrespective of their level of living status to acquire and own properties with just and equitable distribution of wealth.

As a result of the hilah-based debt and fractional reserve system; inflation creates ownership out of nothing without taking any effort and work, and transfers assets from one party to another. And it is even worse as the banking system attempts to supply more and
more credits from time to time into the market, as argued in the headlines of New Straits Times (NST) on the Malaysian budget 2008, on 7th September 2007: What is in the Bag for Budget 2008? More Money (credit). To boost economic expansion. Expect the government to loosen the purse strings (Chang, 2008). This budget has then been criticized by number of Malaysian economists and members of parliament, and among them Kamaruddin: The budget (credit) clearly shows that the government recognizes the rising costs of living and inflation (Chang, 2008).

And Azizah denounced:
We definitely want economic growth but not to have wastage of funds. The budget (credit) is pro corporate sector and not pro to both workers and business owners, especially the small and medium industries (Chang, 2008).

Such a budget looks like the policy gives more power to the banking system that is supplying more hilah-based debt in the market. And as a repercussion of that inflation is certain to rise and purchasing power is inversely to plummet. The hilah-based debts are translated into money supply expansion through the fractional reserve system into the market. And it does disclose an opportunity for consumers to apply for more debt for consumption. As soon as more buyers are able to purchase the limited products in the markets, it does trigger off an increase in the price level. Likewise industrialists, traders, and service providers have to incur high cost of borrowing, and such an increased liability is only possibly covered by the upward price adjustment of goods and services.

With regards to that inflationary pressure, those who are holding money would forgo some purchasing power of that decreasing money value against goods and services. It is a critical case concerning ordinary and poorer sectors of society by which inflation is taking away from them their ability to fulfil some of their needs, even though the said problem (inflation) interferes also with the rich, but the impact on them is not as huge as it is on small-and-medium scale industries and people seeking simply to fulfill basic needs (Mannan, 1987). Meaning to say, less purchasing power is payable by transferring of wealth from one party (small industries, the poor) to others (creditor, the well-off, corporate sector) through price increases. This happens when those who are still holding high purchasing power (creditor, the well-off, corporate sector) would take over the needs that should have been purchased by the small industries and the poor. As mentioned by Meera and Larbani (2009):

(…) Note that the introduction of new money had transferred ownership of assets. But there is now more money in the economic system than before. Ceteris paribus, this is inflationary. Those holding money would have to forego some purchasing power of their money. They can now only claim less real things in the economy. Indeed, the total of the real purchasing power lost by the economy as a whole equals the total value of assets transferred to the businessman/bank. In other words, all subjects in the economy paid for the transfer of wealth through inflation, i.e. through increased price levels.

Figure 1: Transferring of wealth from one party (poor & small sector) to another party (rich & corporate sector) through inflation

<table>
<thead>
<tr>
<th>With $ 5,000 in 2007, Mr. Firdaus deserves to own the whole size of land</th>
<th>With $ 5,000 in 2008, Mr. Firdaus only deserves to own one quarter of the whole land</th>
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<td>Land is affordable by Mr. Firdaus in 2007</td>
<td>Land is affordable in 2008</td>
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<td>Will be purchased by businessmen, bankers, creditors, etc</td>
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Let us say Mr. Firdaus owned $5,000. In 2007 he could have purchased the whole of an area of land. But because of inflationary pressure in 2008, the price level of such a land has increased to $20,000. The only size that is affordable to him in 2008 is one quarter of the original size of land. And how is the rest? The other three quarters would be purchased by those who hold higher purchasing power and they are definitely well-off people from businessmen, creditors, bankers, and corporate sectors; although they (well-off people) are theoretically hit by the inflationary pressure too. This is the way which the transferring of wealth from the poor to the rich, from the small to the corporate sector occurs and ends up with the rich becoming richer, and the poor would remain living in poverty and the rest become poorer. And it has similar impact on the other basic needs such as foods, drinks, houses and so on and so forth.

Meaning to say they (well-off people) have indirectly stolen people’s purchasing power through inflation and surely people are unaware of it. Day by day, month by month and year by year money is losing its value, and the price of goods and services will soar up. It is an effect of inter alia hilah-based debt products and the fractional reserve system where they contribute to indirectly transferring people’s wealth and seizing it from the poor and small industries through inflation. This indicates that wealth has then been centralized among well-off people and the opportunity for poor people and the small sector to gain a more just distribution of wealth clearly disappears. Thus transferring of wealth from one party to another party today has translated the Qur’anic text prohibiting the circulation of wealth among well-off people[3] into today’s impact of hilah-based financing on the socio-economic system.

In such a verse, Allah the Almighty ordered the expenditures of the spoils (ghanima / fai’), so that the wealth does not remain and circulate solely among the rich and well-off people, who would spend it as they wish and desire, and give nothing to the poor, needy (Ibn Kathir, 2000) and small-and-medium sized industries. The circulation intended by the shariah is the dissemination of wealth in the community and into as many hands as possible, and this transfer is not only constrained to the spoils of war, but indeed comprises the whole fair wealth distribution activities in particular trading and commercial activities (Ibn Ashur, 2006).

Transferring wealth from the poor to the rich by means of the excessive uses of hilah-based debt financing through fractional reserve system would never give any advantage to the less fortunate people, otherwise it ensures that wealth and property still remain with the wealthy and more so they are gaining from the losers in market. Hence, the researcher is not in agreement with those advocates of Islamic debt-based products who claim that today’s Islamic banking and financing system is different from the conventional by guaranteeing a just and fair distribution of wealth among all groups of people. On the contrary, those products have actually broadened and enlarged gaps between the well-off and the less fortunate, and this would most likely never be decreased.

Safeguarding the Objectives of Shariah is Hardly Attainable

To realize individual and public benefits, it is then incomplete to solely offer a shariah-compliant system without this being complemented by the objectives of shariah in finance and the economy. Today’s money supply expansion through the fractional reserve system and hilah-based product, looks like a scenario in which the government has granted privatization of money production to private institutions. Commercial and private financial institutions, including Islamic banks, create as much credit as they want for the sake of their own interest. Privatization does not always respond positive aftermath. It is generally possible to say that maximizing profits or returns for private and individual interests are the priority, instead of the public welfare which is normally neglected. It is against the underlying objectives of
shariah where it seeks to stimulate the proper rules of conduct enabling moral and spiritual growth, sharing and cooperation, and preserves the essential interests of the public in general.

Islamic debt-based financing of Islamic banks is based on regulation of reserve ratio[5], imposed by every country’s central bank. Since this regulation was put in place, the central bank is indirectly not able to restrain and discontinue the huge level of debt financing offered by Islamic banks. In contrast, the state in essence is a guardian of the people and their main objective is to safeguard and improve as much as possible the welfare and benefits of the public. The authority of the Imam (government) with regards to the public interest (maslaha) is expressed in the legal maxim of ‘the disposition of the Imam (government) concerning the citizens depends on the public interest (tasarruf al-imam `ala al-ra`yah manutun bi al-maslaha)” (Azzam, 2005). There is no place for inconsistency, arbitrariness, hesitancy and indecision with regards to maslaha, and the maslaha must be secured, firm and unmistakable (Kamali, 2008); and then the maslaha perceived is in place as long as the objectives of shariah have been totally protected.

Verily, there is a support from Western economists, Zarlenga (2004) the director of the American Monetary Institute, emphasizes that today’s monetary deals have little or nothing to do with the real concept of money coming from authorities, but with a concept of privatized credit creation by which the interest of the whole socio-economy can never be guaranteed: (...) Only our government would create money, and it would do so directly, not by making loans. Money’s nature is not a loan credit. That is crucial to remember (...) Using loans to create money would make it too easy for banking elements to regain their private control over money (...) Remove the privilege which banks presently have to create money (...) 100% reserves are reached not by calling in loans and wrecking the economy but by increasing reserves (...) Government money tends to go into infrastructure, like education, roads, clean water, health care and social security.

The realization of the public interest (maslaha) in the socio-economy is by the realization of the objectives of shariah. But money supply by money creation based on hilah-based products would, it seems likely, never guarantee the upholding the five objectives of shariah. It is clearly argued by starting with wealth, money and its value exploitation, and subsequently badly afflicting life, intellect, progeny and faith. As wealth circulates in the hands of those who create money from thin-air and creditors, i.e. private financial institutions, including Islamic bank, the overextension of money and a lack of social responsibility are currently dictating to the whole nation. Many countries are facing monetary crises that have led to a banking system meltdown and nations since then are suffering from such greedily ridiculous banking activities.

As wealth is manipulated and unjust distribution of wealth dominates, people’s lives remain in poverty and some become poorer and poorer, suffering from inflation, a devalued medium of exchange and unemployment. Food, shelter, medicine and education, all are payable for in this modern world. Massive numbers of people are starving and are simply waiting for the end of life. This is simply dangerous to the new born, where even progeny is endangered. Lastly, ‘poverty easily leads to committing infidelity or apostasy (kufr)’ (Al-Bayhaqi, 1410H; Al-Asbahani, 1405H; Al-Qada’i, 1986), as emphasized by the Prophet Muhammad (peace be upon him). So, how the hilah-debt financing system are considered as a stimulant measure and does not have to be condemned. Based on the situation above the objectives of shariah are hardly attainable as long as this system prevails.

Moreover there was a report of Ibn Taimiyya the classical Muslim scholar that stated the importance of money production supplied by the authority (state) and not individually produced to maintain the sustainable markets in the economy. He requested from the Sultan of Mamluki to examine the debasement of currency, since the problem would give a bad impact on the economy. He was against the excess supply of money by which it would be devalued.
and unstable. According to him, only states are responsible for producing real money (minting coins) with fairness and justice to the people are the priorities (Islahi, 1998). The monetary expansion today through money creation with debt-dominated is actually similar to the excess supply of money and its debasement during older times (Sussman & Zeira, 2003), such as that time period of Ibn Taymiyya. It is then confirmed by Al-Maqrizi (1994), according to whom easily producible currency (fulus) led to its debasement; and become the main factor driving inflationary pressure, poverty, economic meltdown and ending up with the collapse of Mamluk’s reign in Egypt (1382 to 1517 AD). The historical fact has become a basis to evidence that the monetary expansion by the modern money creation is simply a same factor driving the debasement of currency through inflationary pressure and creating artificial purchasing power that will never guarantee the achievement of the objectives of shari’ah.

Hence it is not an excuse to not giving more rooms for profit sharing products; by which the products, on the other hand, do encourage people to work by creating better job opportunities, as the investment rate in the market would increase. It has social justice for the public interest (maslahah) with which a necessity to achieve the objectives of shari’ah. On the other hand, the debt-based system does not guarantee the fulfilment of these elements as what is promised by the equity-based system.

**Recommendation**

Instead of a fractional reserve banking system being applied, a full reserve banking system may have to be introduced, or at least the reserve requirement ratio must be increased (Meera, 2006), for the sake of, besides expunging adverse economic impact, eliminating or minimizing the possibility of hilah-based products from happening. A one hundred percent reserve requirement eliminates creating money out of nothing in the banking system (Islamic and conventional) in which the ‘fraction’ is considered to be the multiplier for debt products (i.e. buy-back sale). As a full-reserve banking system is implemented, none of the money creation on top of the deposits would be produced by the private sectors and hilah-based products would be eliminated; it indirectly then serves the absolute right to the government or the authority (i.e. central bank) to produce and control the medium of exchange.

Since the Islamic bank provides debt financing facilities through the fractional reserve banking system, with little positive economic return and less favourable impact on the national welfare as a whole, the researcher is proposing that all Islamic banks should be involved in Islamic investment, by directing the customers’ demand deposits to real productive investments (projects) by sharing risks through a full reserve banking system. The portfolio of investment has to be a diversity of long-term and short-term financing (Ahsan, 2006). According to El Diwany (2003), the investment accounts that be invested with entrepreneurs under profit-sharing or rental contracts would have no reserve ratio. The pools of funds do not belong to Islamic banks; it can be then an off-balance sheet item managed by the banks on behalf of the investors. The money transferred into an investment account could be treated in the same way as an investment fund unit. Any profit or loss is given to the investor, less the agreed share of the profit (if seen as a mudarabah) or management fee (if seen as an agency - wakalah) paid to the bank. On the other hand, Askari et al. (2010) view that the investment banking is a model of an equity shareholding system. When the system does not contain money creation through credit (hence contributes to zero credit multiplier), the investment banking thus pools deposits and invests them by purchasing equity shares. The amount of deposits in investment accounts will be determined by real deposits, but not by the credit multiplier.

However, Chapra (2004) suggests that equity-based financing might take both forms of investment, whether shares in joint stock companies or profit-and-loss sharing (PLS) in
projects and ventures based on **mudarabah** and **musharakah** financing modes. Further, this view is maintained by Al-Jarhi (1996) who proposes the establishment of ‘member banks’ that would undertake direct investment and profit-sharing ventures. Direct investment allows banks to hold shares in enterprises, partake in their administration, and to give technical assistance and expertise, whereas profit-sharing ventures cater for short-term pool of funds to finance businesses or entrepreneurs who need additional financial liquidity support; and after allowing for the financing, returns will be divided between entrepreneurs and banks, based on an agreed formula. The duration of entrepreneurial operations might vary from 60 days to 12 months, while 60 days to 10 years would be appropriate for a direct investment range. On the other hand, he also suggests that banks can provide a small portion or percentage of their pooled resources to interest-free lending, since individuals would expect to consume today’s spending with insufficient resources against a higher level of resources in the future.

Profit-sharing investments through entrepreneurship would give consumers or depositors more chance to obtain a higher income and would indirectly reduce the level of borrowing. Besides, this form of investment is equally important in the development of small- and medium-sized enterprises, many of which might presently lack financial support. By extension, investing in the equity shares of joint stock companies through banks should also be taken into account; customers would obtain the use of bank’s expertise in benefitting from this form of investments.

Therefore, equity investments are not only limited to either profit-sharing or investing in stocks, but both forms of investment have a vital role to play side-by-side in pursuit of economic growth, rather than credits or loans. In addition, making depositors and financial intermediaries partake in risk sharing of investment would motivate the depositors to take greater care in selecting their financial intermediaries, and the financial intermediaries’ management would be forced to assess the risks more cautiously and to supervise or monitor the use of funds by investors more effectively (Chapra, 2004). Hence, this would then attract more depositors in investing with them.

Furthermore, the use of loan transactions for individuals whose future income expectations warrant their solvency is also an important form of financing. In spite of that, it is not really a good idea to suggest that private banks should provide a form of financing, as viewed by Al-Jarhi, but should do so only for a temporary and strictly defined period of time. Instead, government should take this responsibility to cater for loan transactions, since they are considered as the providers and protectors of the people’s welfare. Loan is not a way to gain returns or profits, but it is a sort of altruistic and benevolent deal from one to another. Thus, the issue of who is the loan provider is solved by it being the government, but not the private sector since their objective, as far as the people are concerned, is typically profitability. In addition, if such a loan is provided by banks as is the current situation, credit creation is still on the increase and therefore money supply will be rising onwards towards diverse economic and financial crises thereafter.

With regards to profit-sharing investment, it would be generated, in particular for small-and-medium entrepreneurs, through the role of every single mosque that the administrative position will be managed by mosque’s secretariats (i.e. imam, bilal, and the like) for their own local resident benefits. Islamic banks will have interconnections with mosques in running profit-sharing projects, as capital providers either based on **mudarabah** or **musharakah** contract. This method of conducting investment activities would involve a role of Islamic banks in the mosque environment and not only constrained to financial markets; and indirectly, the role of mosques for building society would be expanded to their socio-economic interest that should actually have been, instead simply a place for prayers. Moreover, Islamic banks might cater for equity-stock investment to local residents at mosques.
whose savings are in excess. Besides, this method would encourage local Muslim residents to get used to going to the mosque for every single prayer time. Accordingly, for those who still need to apply for consumer debt, i.e. mortgaging, purchasing cars, etc., the flow of capital should be directly from the central bank or government, and no longer from depositors’ money. The diagram shows how all deposits of Islamic banking are allocated to investment, and the other (debt-based financing) is financed directly from the government or the central bank.

Figure 2: Full reserve banking system instead of a fractional reserve banking system

A hundred percent reserve system must be realized in lieu of the fractional reserve system, with which it indirectly gives government the authority to control the level of debts.
for those who are in need, and the Islamic bank is given more opportunity to create wealth that involves people depositors, investors and entrepreneurs. Such wealth creation is certainly from new cash flows of deposits to real financing, and finally ending up with creating additional value of real wealth and welfare for all people; as Askari et al. (2010) advocate: ‘New cash flows to an Islamic investment bank originate from new savings, and not from the proceeds of loans transferred from one bank to another. This is, therefore, a wealth creating activity that generates new cash flows, and not money creation at the stroke of the pen.’ With respect to the involvement of mosques as centres for investment projects, interconnecting Islamic banks with local depositors, investors and entrepreneurs, distribution of wealth will surely reach to the very ground of local residents, especially those involved in small-and-medium sized enterprises.

Besides, depositors who are not interested in depositing their money in investment accounts could choose current accounts under the contract of wadiiah and these must be guaranteed without any profit or return. On the other hand, they would be service or administrative charges concerning the facilities offered by the Islamic bank. Hence, this concern would indirectly encourage the depositors to save in investment accounts and gain big returns, rather than being charged. Perhaps, they would divide and put a certain portion of their earnings in investment accounts, and the rest in wadiiah accounts; the returns from investment accounts might be used to pay the fees for wadiiah accounts. This case is then really practical for those who do expect to be able to withdraw at anytime and anywhere. Therefore, the fractional reserve banking system is actually stimulating the level of debt-financing to increase, where it is a main source of the uncontrollable rise in the money supply.

When too much money supply in the economy, it triggers off various financial and economic crises; reducing or at best restricting the positive growth of the economy and degrading the socio-economic interest. Instead, in the equity-based system, the supply of money is not allowed to overstep the supply of goods and services that would end up with effectively curbing inflationary pressures, inter alia, since it is a supply-led market system. However, it is perhaps hard to implement a hundred percent reserve requirement in one go, but it could be based on the means and methods of the Almighty God, who put certain prohibitive rulings into action by gradual steps and stages.

These means and methods are very important in order to give some reassurance to the markets about the changes to the financial system without experiencing a drastic reduction of debt-based practices, and allow for responsive policy modifications over time. As narrated by the Prophet: ‘The best thing in doing something or taking a job is in moderation (khair al-umur awsatuha)’ (Al-Shaybani, 1974). Hence, the researcher put a periodic parameter prior to exercising such a requirement by introducing gradual steps phasing in the hundred percent reserve requirement and the equity-dominated system. The reserve requirement might be appropriately shifted from the current rate of one percent to, perhaps, an initial 33 percent reserve. It is based on the following foundations by referring to the practice of Islamic deduction in Islamic law.

**The Prohibition of Interest (riba) in Three Levels**

Interest or usury (riba) is prohibited in the Qur’an within three distinct passages. By considering the chronological order of the Quranic revelation, firstly, the Almighty God gave a warning in chapter al-Rum (The Byzantines), 30, and in verse 39, as saying: ‘That which you give in usury for increase through the property of (other) people, will have no increase with Allah: But that which you give for charity, seeking the Countenance of Allah (will increase): it is these who will get a recompense multiplied’. Which means to say, Allah grants in multiples to those who spend their money for the sake of no reason other than to please
Him and to win the will of God, and at the same time He also removes from usurers who seek to expand and raise their wealth or capital at other people’s expense (Qutb, 2003). The former is the guaranteed way of increasing money, wealth and capital but not the later. Those who spend on the path of Allah, they are gainers of multiple rewards, not only in this current world but also rewards in the life to come. Society can make profits as long as the socio-economy is strong enough with no exploitation occurs amongst each other in the community, and this would drive towards the fulfillment of the will of God, that He has already guaranteed the rewards of the after-life, but not for usurious market players. This is a general statement that is applicable to all the means that people use to usuriously increase their wealth.

Secondly, Allah has then ordered all believers and warned them never to take interest or usury (riba) at compound rates, as saying in chapter Ali `Imran (The House of `Imran), 3, verse 130: ‘O ye who believe! Devour not usury, doubled and multiplied; but fear Allah; that ye may (really) prosper’. When financial sectors rely on usury, it makes the financial cycle revolve around it. All Muslims have to take into account that every single usurious transaction does not only stop at that point, but it is repetitive and compounded. When the element of time is added to these two aspects, it does for sure lead to the exponential multiplication of the principal or capital over time (Qutb, 2003), as is going on with the Islamic debt-based financing underlain by fractional reserve system today that is ubiquitously available in Islamic markets. This is the nature of the usury system that is unlimited in its potential to expand.

Thirdly, interest and usury (riba) in all forms were utterly condemned, and those who take ignore its prohibition are warned of a holy war against them by Allah and His Messenger, as in chapter al-Baqarah (The Cow), 2, verse 275-279:

Those who devour usury will not stand except as stands one whom the Satan by his touch hath driven to madness. That is because they say: ‘Trade is like usury’, but Allah hath permitted trade and forbidden usury. Those who after receiving admonition from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are Companions of the Fire: there will be abide therein (for ever) (...) O ye who believe! Fear Allah, and give up what remains of your demand for usury, if you are indeed believers. If you do it not, take notice of war from Allah and His Messenger: But if ye repent you shall have your capital sums: Deal not unjustly, and you shall not be dealt with unjustly.

The verses have made a final passionate appeal to the true believers to desist totally from usurious activities, or face a relentless war undertaken against them by none other than the Almighty God and His Messenger. The Qur’an is very clear and unambiguous on this matter, and leaves no room for doubt or confusion. The true believers have no chance at all to pronounce their faith and belief in God verbally, only to take up a way of life that is opposite to His laws (Qutb, 2003). The war that has been warranted by The Almighty God and His Messenger and promised to be waged against usurers covers every single aspect affecting psychology, economy, emotion, conflict, instability, human civilization and ending up with the final punishment on the Day of Judgment.

**Highest Islamic Willed Bequests up to One Third**

The reason for proposing the fractional reserve moves up to 33 percent from the current rate of one percent as the first step is because, inter alia, the maximum bequest in Islamic law is given out as one third (Ibn Hajar, 1999), as the Prophet (peace be upon him) approved:

Sa’ad Ibn Abi Waqqas narrated that (once) I fell seriously ill in Mecca and the Messenger of Allah (peace be upon him) came to visit me. I thought it was very bad for me to die on the soil of Mecca from which I had migrated (and which I had left for good for the sake of God). The Messenger of Allah (peace be upon him), then said (by way of prayer and consolation): May Allah have mercy upon ‘Afra’s son (‘Afra’ was the name or title of Sa’ad
Ibn Waqqas’s mother). I asked him: O Allah’s Messenger, may I will all my property (for the sake of God)? No, the Prophet replied. I said: Then may I will half of it? He said: No. I said: One third? He said: Yes, one third, yet even one third is too much. The Prophet then observed: It is better for you to leave behind your heirs wealthy than to leave them poor begging others (…).

The highest rate of wills or bequests is one third of the entire wealth that has been legalized in Islamic law by a consensus of Muslim jurists, and it is then impermissible that it be more than that. Further, wills or bequests will be taken place after all outstanding debts and loans have been fully paid off deducted from the deceased’s wealth (San’ani, 1999). Hence, 33 percent or one third of the 100 percent ratio of reserve system might be put into place and substitute for the established one percent ratio. It is the first approach based on the maximum rate of allowable bequests under the Islamic law.

The Prohibition of Alcoholic Beverages within Three Time Periods

By extension, the upgraded reserve requirement by one third to 33 percent is also based on the three time periods of alcoholic prohibition. This case saw a gradual period of time to the prohibition before it was completely forbidden. Such a gradual prohibition is perceived to be a must, since the nature of human beings is typically against as immediate implementation in one go, additionally drinking is well-established social habits in that time that needs careful step-by-step treatment (Qutb, 2003). Therefore, such prohibition started by raising an inner consciousness of alcohol’s harmful effects in people’s minds, giving advices that it would be better expunged. Allah explained: ‘They ask thee concerning wine and gambling, say: In them is great sin, and some profit (benefits) for men; but the sin is greater than the profit’ [6]. The explanation was the first loud knock on the door that was bound to have its effect on the Islamic conscience (sense of right and wrong) through legislative logic, of their harm or evils are clarified as greater than benefits that make drinkers think about that.

Then, the second approach came later on which directed Muslims: ‘O ye who believe! Approach not prayers in a state of intoxication (drunk), until ye can understand all that ye say’ [7], as Qutb then inferred that the obligatory daily prayers are five times and the time interval between one prayer to another is not long enough for drinkers to get back to sobriety. Therefore, that very short interval will restrict drinkers from having the opportunity to keep on drinking and help them to forgo it altogether (Qutb, 2003). The third and final step was completely banning the drinking habit after people had become fully ready to accept it, by pronouncing a decree in the verse which directs: ‘O ye who believe! Intoxicants and gambling, sacrificing to stones, and (divination by) arrows are an abomination of Satan’s handiwork; eschew such (abomination), that ye may prosper’ [8]. Further, Umar Ibn al-Khattab, a companion of the Prophet (peace be upon him), for instance, stopped taking alcohol and declared his submission when the final express prohibition was revealed as above, while he was already a Muslim during that time (Qutb, 2003). And of this Umar’s case, inter alia, shows of how the well-entrenched habits of drinking alcohol were during that time.

Therefore, these foundations could possibly become strong bases towards upgrading the reserve requirement to 33 percent from the very low current ratio. Although the current financial system is likely yet to be 100 percent reserve requirement and fully-fledged equity (or equity-dominated financing), but the guidelines shown by the Almighty God on interest and usury (riba) prohibition, suggest that it is best to treat the well-entrenched excessiveness of debt in financial system by stages and phases, not in one go. In addition to interest prohibition, this gradual process is also braced by the three phases for the banning of alcohol and the one third legally bequeathed. Nevertheless, the main objective does not stop at this level; it should pursue further efforts to ensure 100 percent reserve and equity-based system
be positioned in Islamic banks. With respect of this 33 percent implementation, we are then on the first step to Islamizing all conventional banks without declaring or imposing regulations forcing all conventional banks to shift to Islamic forms.

**Conclusion**

Although Islamic debt-based financing has provided some interest and benefits to the economy, but it is limited to few of the market players and not for the whole socio-economic interest. Inflationary pressure, devalued national currency, indebtedness, default and poverty are the factors demoting the economic growth by which safeguarding the five objectives of shariah might be made impossible. Hence, just distribution of wealth is obviously impossible to materialize as the gap of standard of living is never decreased between the rich and the poor.

Debt-oriented of Islamic banking products amounted more than 90 percent of overall Islamic banking products. Although it became a financing facility for consumers and borrowers, but they have been misleading people towards oft-indebtedness and excessive use of debt that put them and the economy into destructive circumstances. People and financial institutions are eager to use debts and credits as a primary source of earning and income, rather than utilizing wealth-creating investment products. Therefore, it does not really reveal favourable and splendid impacts on the economy. Various impacts have been exposed and the aftermaths of this have been clarified to show that the involvement of debt-based is not really valued in the economy.

In addition, the researcher intends to suggest and recommend that the economy should be moved away or not really dependant on debt products. There is a need to move further from a fractional reserve to a full reserve banking system as the current situation of economy. The transformation from the current system to the better system would mitigate the use of hilalah-based debt and its adverse impact on the economy, since it (the fractional system) is the principle for debt or credit expansion. Nevertheless, in order to make sure that the transformation is effectively delivering, gradual steps forwards to its implementation should be taken into action, as it is a methodology of Allah’s revelation to His creation. Again, human beings will better accept a new matter if it is imposed in gradual steps and stages, but would be much more likely to oppose it totally if it is carried out at one strike. It is hoped that the research will provide an insight to the market in particular to the Islamic financial institutions, authorities and governments on what should be done in order to overcome unfavourable social economy.

**Notes**

1. Tarek El Diwany *et al.*: ‘Reform of the monetary system that produces inflation is the key to success in this matter (…)’.
2. Mohammad Nejatullah Siddiqi: ‘In a debt-based economy, the money supply is linked to debt with a tendency towards inflationary expansion’.
3. Allah ordained: ‘(…) in order that it may not become a fortune used by the rich among you’. (Surah al-Hashr, 59: 7).
4. Five objectives of shariah is protecting wealth, life, intellect, progeny and faith.
5. For example: Statutory Reserve Ratio (SRR).
References


Usmani, M. T. (2005), *An Introduction to Islamic Finance*, Maktaba Ma’ariful Qur’an, Karachi
