The current issue and full text archive of this journal is available on Emerald Insight at:
www.emeraldinsight.com/0828-8666.htm

Methodology of institutional analysis and its implication for contemporary framework of Islamic banks

Omar Javaid
College of Management Sciences, PAFKIET, Karachi, Pakistan

Abstract

Purpose – This paper aims to investigate the possibility of a methodological error made by the concerned scholars and academics of Islamic finance & economics to understand and study the modern framework of financial institutions, where they intend to practice Islamic law of contract. This error has led them to expect something which the institutional modern framework of banks, adopted by Islamic banks (for e.g.), wasn't designed to accomplish, hence the disappointment.

Design/methodology/approach – This study reviews the literature on history of evolution of banking industry and the corresponding ideological and cultural changes in the European society which drove this evolution; this is followed by a conceptual analysis to identify the institutional components inconsistent with ethos of Islamic norms and ethos.

Findings – After review of history and evolution of modern banking framework, in the light of Hollingsworth frame of institutional analysis, it is inferred that the said framework was designed for a secular, liberal and capitalist society to efficiently and effectively enhance freedom and accumulate capital and wealth, without much regard for equitable distribution of wealth and economic justice. These goals are very much in contrast with the normative premise of Islamic Economics, which cannot be efficiently used to achieve the related objective. This indicates that framework of banking was narrowly understood by the concerned scholars and academics, without considering its history of evolution and intended objectives, before adopting for IBs.

Practical implications – The disconnect between the Western institutional framework and ethos of Islam implies that the concerned need to look deeper and holistically while adapting Western institutions, so that necessary alteration is done in advance, if such an adoption is inevitable.

Originality/value – This study introduces a new dimension for the concerned scholars, academics and practitioners to reanalyze the institutional framework adopted from the West, so that necessary adjustments can be worked out to make the said framework compatible with the ethos of Islamic economics.

Keywords Islamic banking, Institutional evolution, Real bill doctrine

Paper type Conceptual paper

Introduction

All kind of institutions, which are well-established in today's world, have a history and have evolved to achieve specific objectives. Let it be social, economic or political institutions, none of them emerge spontaneously in a society. Likewise, the evolution of modern banking institution has occurred over a long period in history (around 400

JEL classification – B13, B52, D02, E02, G20, P10, E31

Humanomics
Vol. 31 No. 2, 2015
pp. 183-200
© Emerald Group Publishing Limited
0828-8666
DOI 10.1108/H-07-2013-0051

المنارة للاستشارات
www.m

years), in which socioeconomic and political forces shaped its structure or framework, making it more and more efficient over a period of time to fulfill certain financial and economic objectives valued by the particular kind of a society.

This society was formed in Europe after the fall of renaissance and under the influence of enlightenment movement which revolutionized the face of the European societies by altering the very meaning of life, definition of a mankind and his purpose of existence, subsequently taking the society away from the dominance of religion and while replacing it with a secular worldview. This transformation was cosmological, ontological, epistemological and teleological in nature. The economic institutions with their framework (which included the functionality, operations, objectives, along with the legal support from politically backed regulatory authorities), evolved, got refined, shaped in due proportions and gained a strong hold in the same society, while conforming and facilitating the new meaning of life and its purpose. This new purpose was to advance and grow on a worldly plane, by maximization of wealth, capital and freedom. In the light of Choudhury's (2008) views, the methods of trade, finance and economics evolved in alignment with the popular materialistic "epistemological-ontological-ontic methodology" which replaced the religious one in Europe.

This implies that an institution like a bank, insurance firm, central bank or stock exchange, etc. is not an entity which exists in isolation; instead, it is a part of a larger socioeconomic system and can only function effectively and efficiently within the society for which it has been designed for – a society with a distinct belief system, values, traditions, history, norms and cultures. Unlike machine components (metaphorically), these institutions also have self-interests, survival instincts and a desire to expand and grow; therefore, they would want to reinforce and appraise necessary conditions in the society, which would allow them to survive and grow, while discouraging those conditions which would threaten their survival. The same institutions may or may not perform efficiently or effectively in a different kind of a society depending upon the extent to which that values and norms of that society are compatible from where that institution has originated; their survival instincts would force them to influence the values and norms so as to make them conducive for their survival.

In this context, it should be asked that what implication such a holistic picture of a bank (in which it is not seen in isolation, rather as an efficient and effective component of a society found on non-religious values, norms and traditions) would hold for scholars and academics of Islamic banking and finance. What expectation should be attached with such an institution? Metaphorically, if a tractor is designed to plough the ground, then would it be efficiently and effectively be able to serve in a hospital's emergency ambulance service? If that's the only option, then what should be our expectation from this tractor?[1] If, in case, tractors are selected for this purpose and introduced in all the hospitals in a society, then, gradually over the period of time, institutions will have to to repair, maintain and manufacture spare parts; train people to do all this; design roads that could bear the load of traction; train manpower who knows how to design and maintain such roads; import whatever is not available; understand the side effects of pollution caused by tractors; research on how to reduce these side effects and the number of people who dies on the way due to slow speed; handle legislative matters to handle the grievance of relatives of deceased patients; or even reduce the extent of

www.m

sanctity of human life at legislative or constitutional levels, so that the tractor-based emergency service remains operational, etc. […].

This would mean that to fulfill the objectives, for which the institution is not really designed, significant alteration within that institution might be inevitable. Would these alterations be limited to the contractual relationship the institution holds with its stakeholders or it would have to be more endogenous; or, it would rather be better to create a new institution from scratch, instead of altering the existing ones, to fulfill the socioeconomic and political objectives of a particular society, or instead, legitimize the objectives of the adopted institutional framework.

Therefore, before attempting to Islamize an institution evolved in a secular society, it may not to be analyzed in isolation. A complete holistic picture, which includes various layers of dimensions, as explained by Hollingsworth (2000), is needed before any attempt is made to Islamize it. Why such a holistic evaluation of the banking institution has not been attempted until now by the concerned academia and scholars and why a text book definition of the banking institution was taken for granted for that matter is not clear. The text book description of the institution allowed the concerned to perceive the bank (or insurance company or stock market, etc.) as value neutral within its design, something which does not require much amendment, and maintain focus to Shariah compliance of contractual relationship of the banks alone[2]. However, as a result, this compartmentalized understanding has been nothing short of disappointment.

There are various voices in academia and Islamic scholarship expressing concerns in different capacities[3]. This also includes scholars like Mufti Taqi Usmani who complain Islamic banks (IBs) to have promoted the debt-based products, ignored *musharakah* and *mudarabah* and tried to follow the foot step of conventional financial industry by behaving in a similar way while not promoting the ethos of Islam in the area of finance and economics (Usmani, 2008). Such voices imply that the expectations from the respective institutional framework were unrealistic. Was it really compartmentalized understanding of institutional framework which led to such unrealistic expectations? This is a question which will be probed in forthcoming sections.

This paper, although not exhaustive, intends to introduce new basis of evaluation of the institutional framework, particularly for Islamic financial institutions (although it can be used in general for any kind of institution). Let us hope that such an analysis is never too late. This paper does not intend to challenge the current position of Islamic banking, but the expectations attached to it by the academia and scholars, what went wrong and needs to be done in future to avoid such disappointments, and to make Islamic financial institutions more compatible to the ethos of Islamic Economics.

The first section would provide a theoretical structure of institutional analysis, followed by an analysis of the norms, values and ideological transformation of European society and how it influenced the evolution of banking institution and the socioeconomic objectives for which it was designed. The last section would discuss the implications with conclusion.

Understanding an "institution"

Institutions are organizations of interdependent individuals, linked to each other in hierarchy, having distinct roles and duties, sum total of which forms the teleological

المنارة للاستشارات

www.m

orientation of the entire institution or, in short, would cumulatively determine the role and duties of an institution in a society (SEP, 2007).

English language and the economic system, for example, have also been classified as institutions, but they do not pose an organizational form (SEP, 2007). Veblen (1912) has also regarded social habits like habits of acquiring ownership and forming hierarchy according to the extent of ownership as the most fundamental types of social institutions while assuming the evolution of Western institutional forms as a natural outcome of the process of natural selection (in a very Darwinian context).

Veblen's perspective is too abstract and narrow for the nature of analysis required in this paper. Hollingsworth's (2000) explanation regarding the nature of institutions, however, is more generic, systematic and concrete, hence relevant for us here. Hollingsworth hierarchically arranges different levels of institutions, each one of which:

> […] is interrelated with every other [level] […] and [has argued that] changes in one is highly likely to have some effect in bringing about change in each of the other.

Among the five layers of institutions, the first is composed of "norms, rules, conventions, habits and values" (most of Veblen's analysis is focused on this level); second contains "institutional arrangements" like "markets, states, corporate hierarchies, networks, associations, communities", which are evolved out of the first layer; and the third layer comprises "institutional sectors" like "financial system, system of education, business system, system of research". Regarding the interaction among these levels, Hollingsworth notes the following:

> The rules, norms and values of a society influence the array of institutional arrangements, [which subsequently] influence the nature of and the relationships among various institutional sectors, and all […] [of these are] intricately linked together to form a social system of production […] [which as a whole] influence the performance of economic sectors within a society as well as the performance of the total society (Hollingsworth, 2000) (Figure 1).

In this paper, the term "institution" refers to the ones which exist in organizational form. This form, in view of Hollingsworth, exists at the fourth level. Acknowledgement and authorization of regulatory bodies, "meta-institutions", make it possible for organizations to exist in a society (SEP, 2007). It is believed that the regulators, whose prime responsibility is establishment of justice, acknowledge or authorize any

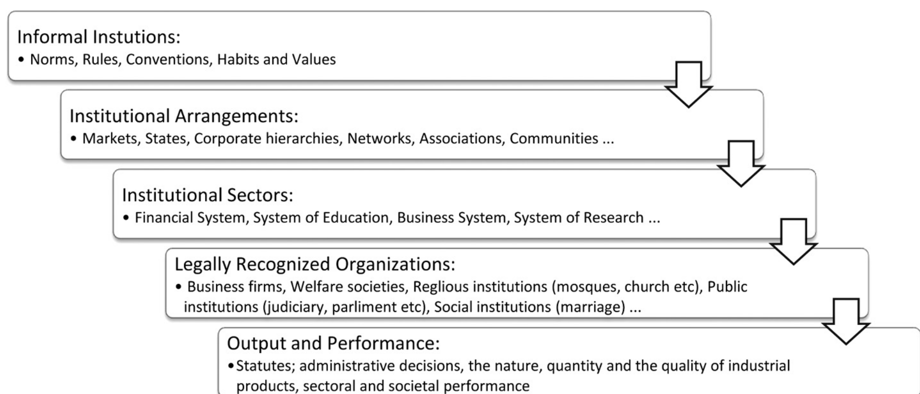

Figure 1.
Hollingsworth (2002) layers of institutional analysis

المنارة للاستشارات
www.m

institution when its existence allows advancement of justice to its stakeholders. In this regard, Hollingsworth is worth quoting, he writes the following:

> There has emerged a vast literature which demonstrates that within each society there are fiscal, political, and judicial and other regulatory norms which limit and shape the culture and structure of organizational behavior. The normative institutional environment of organizations limits the options of what organizations do […]. In short, it is the normative environment of organizations which defines within a particular society what is socially acceptable behavior for organizations.

This normative environment defines the authorization, acceptance and rejection criteria for the design of institutions in organizational forms. After authorization, these institutions are bound to refrain from violating the standards of the normative environment. These institutions also not just interact with its stakeholder but also with the society where they exist. Therefore, the internal functions, features, roles, rights, duties and priorities of these institutions, which constitute the framework of a particular institution, also need to conform to the exogenous normative environment. The outcome and performance (see Level 5 above in the Hollingsworth framework) would also be consistent with the stated normative premise and the first level of "informal institutions", which would also provide a feedback loop to gauge and correct the performance accordingly.

Seeing from this perspective, the institutional framework of conventional banking system has organically evolved in Europe after renaissance period, under the influence of enlightenment movement, to serve ideals, values and norms of the respective society, which would be antagonistic with that of Islam (Rabb, 2006, p. 138). Keeping this in view, the objection on IBs, from the orthodox circles particularly, for mimicking the product and service structure of conventional banks and follow in their footsteps while competing with them directly, is not astonishing. IBs also seem to lack motivation to promote socioeconomic justice as defined by Islamic epistemology; on the contrary, in an attempt to compete with their conventional counterparts, they seem to encourage extravagance, desire of wealth accumulation, competition in worldly matters, prefer to serve the rich class, ignore the needs of the poor etc., as it might be necessary for their own profitability as well, and maintain their performance as per the industry standards of conventional banking.

Therefore, to correct our expectations or understand the degree of adjustments necessary to bring the institutional performance as per the desired expectations, it is suggested in the light of framework of institutional analysis suggested by Hollingsworth that it is not just the institution itself but the whole atmosphere in which the institution has evolved that needs to be brought under the lens of scrutiny. This is required to the correctly understand the nature and internal functionality of banking system, which derives its behavior in the marketplace to achieve specific ends valued by the beliefs, value system, norms and traditions of the very society where banking system has evolved.

Banking institutions

Among various forms of financial institutions, banks are believed to be financial intermediaries between someone who has money and someone who is in need of it. During this process, they charge what is known as profit, markup and interest over the loan they provide to the borrowers or clients (IBs would use Shariah-compliant modes of

المنارة للاستشارات

www.m

finance like *murabahah*, *ijarah*, *istisna*). Banks also provide services like safeguarding deposits or valuables for their clients and transferring funds to distant geographical locations in exchange of a fee. They also share some of the interest earned with the depositors as well. The leftover, also known as the spread, minus operational expense is the net profit of a bank. Albert S. Bolles explains:

> A bank is a means for organizing capital whereby its full power may be utilized. The function of a bank in storing up capital, and thus increasing its power, has been likened to that of a dam put across a stream […]. Banks are useful as places of security for the deposit of money […]. A greater profit is acquired by the owners of money than would be if banks did not exist. […] Banks loan money to persons who wish to borrow it. Loans are made chiefly to persons engaged in manufactures, trade, commerce, and other business pursuits (Bolles, 1,892).

Reisman has also emphasized on how financial institutions including banks facilitate a capitalistic society[4] to achieve its very ends, in the absence of such markets, Reisman believes, savings of the public would go to waste and would slow down various important functions of a capitalistic market such as payment of wages[5], purchase of raw material, etc. if the corporation does not have the capital at his disposal. Therefore:

> […] in contrast, the existence of financial markets and financial institutions, and the rate of return they provide, greatly encourages the investment of all such savings. The fact that financial markets and financial institutions exist thus raises the relative demand for and production of capital goods and thereby powerfully contributes to capital accumulation and a rising productivity of labor (Reisman, 1998, p. 465).

Capital accumulation and increased productivity are the very ends sought by a capitalistic society, as discussed above and in Reisman's view, financial institutions like banks are a means to achieve this very end.

History of evolution of banking framework in the context of Hollingsworth's method

In Hollingsworth's method, the first layer of informal institutions and the last layer of institutional outcome are crucial for our analysis here. History of this evolution, in genealogical format, will be analyzed specific to the formation of banking institution. Reference to specific levels in Hollingsworth framework will be given in between the text to allow the reader to connect the discussion with the respective framework. It is not possible to dig deep down as much as the Hollingsworth framework allows us; however, only necessary details to understand the objectives of the banking structure would be highlighted to achieve the goal of this paper. Let us begin from the brief history of the institution itself.

Albert Bolles has explained, while quoting various historians and scholars, that the concept of modern banking has emerged in Venice in 1171 when the government, who was in need of money to fight in a war, created a public fund in which each citizen contributed. Government issued a certificate to each citizen against their loan and paid interest at 5 per cent to each in lieu of his contribution. A commissioner was also appointed for this task. The Germans termed this system as a "Banck" at that time, which was later recalled as a "Bank" by Benbrigge, an English writer, in 1646 (Bolles, 1892).

However, De Soto, in a footnote in his book, claims the concept of taking deposits and advancing them as credit dates back to 3300 BC; even in India, the concept can be traced back to 2300-2,100 BC; however, commercialization of this concept did not occur until

المنارة للاستشارات
www.m

730-540 BC because of unavailability of safe trade routes. Later, it spread to Egypt and then to Greece (De Soto, 2009, p. 40).

In the beginning, the banks' function was to keep the deposits safe with them:

> Clients made deposits for reasons of safety and expected bankers to provide custody and safekeeping, along with the additional benefits of easily-documented cashier services and payments to third parties (De Soto, 2009, p. 49).

In the beginning, banks were not expected to lend money; only a small fraction of domestic loans came from the banks (De Soto, 2009, p. 49). However, in view of De Soto, since the very beginning of this concept (as it has been witnessed in various documented instances in the History of Room, Greece, Egypt and Europe, even during the middle ages), the depository owners find it hard to resist the "temptation to appropriate deposits [use them in some business activity], a fraudulent activity which was relatively safe as long as people retained their trust in bankers" (De Soto, 2009, p. 49).

The depositories without the knowledge and willingness of the depositors used the amount, entrusted upon them for safe keeping, to earn profits by investing them in businesses. This was shear violation of the trust of the depositors, as many times, as it has been reported and cited by De Soto, that this misappropriation often result in loss due to man-made or natural reasons, destroying the very cash amount entrusted upon them. This was tantamount to theft in view of Roman Law (De Soto, 2009, p. 31). De Soto cites numerous examples from various periods since the very beginning of deposit-keeping practice that such misappropriations by the banks or depositories often ended up in bankruptcies, putting the very people at loss, who in first place put their trust on the bank for the safe keeping. Bank-run occurs for the very same reason when the public who have entrusted the banks with their deposits felt that the banks might have lost their money or does not have it; the bankers, says De Soto, "throughout history have experienced numerous bank runs" (De Soto, 2009, p. 393).

Initially such adventurous misappropriations were done by depositories alone; however, looking at the enormous profits made by these banks in the short run, also tempted the governments "for reasons of mutual interests" (De Soto, 2009, p. 46) to team up with the banks in an act which was considered fraudulent by social and legal conventions of their respective time.

The legal justification was subsequently forged to allow the misappropriation of the deposited amount by the banks, which, in De Soto's view, does not make any sense even within the very legal framework where this justification was sought. De Soto asks:

> [...] depositors hand over money [to the banks] as if making a deposit, and bankers receive it as if it were a loan. Yet, what kind of contract has two essentially distinct legal causes? Or to put it another way: How is it possible that both parties to the same contract simultaneously intend to retain the availability of the same sum? (De Soto, 2009, p. 136).

It is interesting to note, as De Soto also highlights, that such an allowance was given only to the banks but not to other traders who were prosecuted when they used the same misappropriation of the fungible items (like wheat or oil) entrusted upon them by their stakeholders. De Soto here quotes Rothbard, Murray N. (*The Case Against the Fed.* Auburn, Ala.: Ludwig von Mises Institute, 1994, p. 43) who also wonders:

> Why did grain warehouse law, where the conditions – of depositing fungible goods – are exactly the same [...] develop in precisely the opposite direction? [...] Could it be that the

www.m

bankers conducted a more effective lobbying operation [with the government] than did the grain men? (Ludwig von Mises Institute, 1994, p. 125).

The bankers have not always been successful in getting away with misappropriations, as during 1927 and 1934, the courts of Paris and Spain, respectively, convicted bankers for violating the trust of their depositors and demanded to maintain 100 per cent reserve for that matter (Ludwig von Mises Institute, 1994, p. 11). Such incidents of conviction were not very common, as in most cases, bankers were able to find legal justification of what they do.

This suggests how, to achieve certain objectives, banks were allowed by government, meta-institutions, to operate and benefit them, as well as to finance their extravagance like wars, etc. De Soto's references of legitimization of otherwise illegal practices of banks are brief but meaningful examples of how the banking institution evolved from second to third and fourth layer of Hollingsworth framework. Let us see below how the first and the last layers of Hollingsworth framework synchronize with these three in context of institutional evolution.

Modern banking framework and ideological transformation in Europe

De Soto, while citing Carl Menger (founder of Austrian School of Economics), has explained that:

> […] social institutions arise as the result of an evolutionary process in which innumerable human beings interact, each one equipped with his own small personal heritage of subjective knowledge, practical experiences, desires, concerns, goals, doubts, feelings, etc. By means of this spontaneous evolutionary process, a series of behavior patterns or institutions emerges in the realms of economics and language, as well as law, and these behaviors make life in society possible (De Soto, 2009, p. 21).

In view of Joseph Schumpeter, the banking framework:

> […] brings out the peculiar mechanism of saving and investment that is characteristic of full-fledged capitalist society and [highlights] the true role of banks in capitalist evolution (Schumpeter, 2006, p. 1080).

A capitalistic society which believes in liberal and secular values, considers wealth maximization and subsequent freedom maximization (without hurting other's freedom to do the same, at least in theory) as an ultimate goal of mankind's existence (Reisman, 1998, p. 52).

Keeping this in view, the ideological influence of capitalism (having its basis in liberal and secular worldview) on the evolution of financial institutions after the European renaissance and during the enlightenment movement cannot be ignored. Capitalism as a social system also evolved during the same period; therefore, it is safe to assume that banking institutions which evolved organically in Europe during or after middle ages were meant to serve the very end which was sought at social and individual level under a capitalistic society. Therefore, such a legacy of capitalistic evolution would have nevertheless influenced the nature of banking institutions. According to Reisman:

> Capitalism is a social system based on private ownership of the means of production. It is characterized by the pursuit of material self-interest under freedom and it rests on a foundation of the cultural influence of reason […]. It was no accident that the gradual development of capitalist institutions in Western Europe that began in the late Middle Ages paralleled the growing influence of prosecular, proreason trends in philosophy and religion, which had been

المنارة للاستشارات
www.m

set in motion by the reintroduction into the Western world of the writings of Aristotle. It is no accident that the greatest era of capitalist development – the last two centuries – has taken place under the ongoing cultural influence of the philosophy of the Enlightenment (Reisman, 1998, p. 19).

In the wake of enlightenment movement, when such values and life objectives were gaining acceptance in a society, a shortage of money was felt to pursue wealth maximization by the society as a whole. This was the time when metallic money was used like coins of gold and silver, and their circulation was finite in number. In this regard, Carl Wennerlind has made an interesting observation while studying the monetary history of England from 1620 to 1720; he notes that various intellectuals and scholars turned to alchemy (a pseudoscience of converting lead and other metals into gold) to eradicate the scarcity of money, and in this pursuit, bank's ability to issue credit was valued in the same light:

In England, confidence in the utility of alchemy was widespread. It was therefore unsurprising that metallic transmutation was pursued as a solution to the stubborn scarcity of money problem that had severely curtailed England's commerce for decades. Numerous ambitious projects were launched; some were undoubtedly motivated by personal enrichment, while others were designed to generate a more flexible money stock. Despite many reports of successful transmutations, efforts to find the lever that would give mankind control over the money stock failed to materialize. At this point, the same social reformers who had pursued alchemical transmutations switched their attention to the promotion of a generally circulating credit currency, authoring some of the first proposals for such a currency. The similarity between alchemy and credit was far from lost on them, with one person suggesting that a well-functioning bank is: "Capable of multiplying the stock of the Nation, for as much as concerns trading in Infinitum: In brief, it is the Elixir or Philosophers Stone" (Wennerlind, 2012).

Keeping this in view, when capital already available is in finite number and "wants" are infinite, then an institutional arrangement which would make capital available in as much quantity as required to fulfill the exuberant desires of individuals or the government to wage wars may become necessary. This bank did this through their peculiar fractional reserve system, by offering credit as much as ten times the quantity of the deposits they have (depending upon the cash reserve requirements from the central banks of the respective country). An economic goal of the society can be seen to have influenced the formation of an institutional framework here, referring to Hollingsworth framework.

To explain this De Soto argues (while referring to a another source):

[…] if each bank could lend two thirds of its deposits, the total amount of loaning power got by the banks would amount to three times what it otherwise would be. If it could lend four-fifths, it will then be five times, and so on. The question how large, a part of its deposits, a bank can lend depends in a great measure on the extent on which the different banks directly or indirectly pool their reserves.

After an extensive empirical analysis on the phenomenon of how artificial money out of nothing is created when deposit are misappropriated by the banks De Soto infers the following:

[…] banks actually grant loans from nothing and back them with deposits they also create from nothing. Therefore, rather than credit mediators, they are ex nihilo creators of credit […].

المنارة للاستشارات

www.m

> Though banks appear to derive their profit mainly from an interest rate differential, we know that in practice the chief source of their profit is the ex nihilo creation of money, which provides banks with financing indefinitely. Banks appropriate these funds for their own benefit and charge interest on them to boot. In short, bankers create money from nothing, loan it and require that it be returned with interest [or profit] (Royal Economic Society, Macmillan, 1926, p. 199).

Joseph A. Schumpeter has also explained:

> [Depositors] lend nothing in the sense of giving up the use of their money. They continue to spend, paying by check instead of by coin. And while they go on spending just as if they had kept their coins, the borrowers likewise spend "the same money at the same time". […] It is much more realistic to say that the banks "create credit", that is, that they create deposits in their act of lending, than to say that they lend the deposits that have been entrusted to them (Schumpeter, 2006, p. 1080).

Henry Dunning Macleod also noted so a century earlier:

> Those banking Credits are, for all practical purposes, the same as Money. […] They are, in fact, Capital created out of nothing […] it appears that in 1,884 there were, in Scotland, 108,582,418 of Banking Credits maintained on a basis of 4,220,258 in cash, which was, for all practical purposes, an augmentation of 104,856,160 to the monetary resources of the country (Macleod, 1906, p. 408).

Fractional Reserve System eventually gave birth to:

- bank notes, as an alternative of metallic cash; and
- central bank, as a regulator and lender of last resort in case of a bank run.

Bank notes (like bank checks, pay orders and demand drafts, etc.) were issued in excess to the available stock of metallic currency, therefore, by virtue of legitimization of fractional reserve system. However, once the public demanded redemption of their receipts or bank notes, the bank had to declare bankruptcy. As explained earlier, this was sheer violation of public trust; however, it was legitimized through lobbying for mutual interest of banks, governments and perhaps also of the elite class. To tame the public, the concept of central banking emerged.

Over the period of time when central banks also could not pay off liabilities of private bankers, usage of gold and silver coins as a medium of exchange was banned, and the public was forced to use bank notes only (or currency notes issued by central banks). Despite the ban of using gold and silver as a medium of exchange, the currency remained backed by gold until the termination of Bretton Wood agreement in 1971, when the USA was not able to issue gold in enough quantity in lieu of the amount of dollars possessed by various countries (Stephey, 2008). No one dared to call it an international monetary fraud of a colossal magnitude.

The story summarized in the above two paragraphs is, in fact, long and has been described in detail in plenty of works of literature. It is to be noted that the gradual replacement of "metallic money" with "credit-based fiat paper note" and "financial capital" cannot be assumed to be void of the motivation of unprecedented wealth accumulation for freedom maximization for pleasure maximization, as Wennerlind (2012) explained; not to mention, the political power it brings to those who owns and controls the respective institutional framework. Financial capital is now also considered

للاستشارات المنارة

www.m

as an asset, allowing the desire of accumulation to be fulfilled, which otherwise cannot be fulfilled in the world of finite real wealth (Ansari, 2004).

Institutional behavior. The shady history of banking institutions, the nature of risk they carry because of fractional reserve system and their interest to maximize profit eventually force them to remain careful and cautious to maintain public trust, as without it, the public would pull out their money, leading to collapse of the institution. Having said this, banks prefer to provide a loan on fixed return basis or interest against collateral, generally (or in some cases on good cash flow history also).

The depositor is also more interested in safe keeping then earning a return on its deposits (as this is how banks have promoted themselves); therefore, banks naturally incline toward investment opportunities which are less risky yet profitable. On the other hand, various private banks exist who compete in the market to maximize their profits by maximizing their investments, which is possible only when they attract more depositors in a competitive market place. Logically speaking, in theory and in practice, profit maximization temptations and tough market competition eventually incline banks toward:

(1) offering greater profit at a lesser risk to depositors, to attract more of them;
(2) focusing on developing new debt/loan-based financial products for borrowing customers because of the lesser risk involved;
(3) prioritizing depositor's concerns over borrower's concerns to:
   - minimizing bad debts;
   - improving recovery rates; and
   - making stringent policies for borrowers to recover the installments or collateral in case they default[6].
(4) marketing their debt-based services and products to attract both depositors and borrowers, subsequently extending their credit base;
(5) investing in areas which are least risky to keep the trust of their depositors; i.e. maintain less focus on small and medium enterprises and micro borrowers;
(6) preferring rich depositors and borrowers over poor depositors and borrowers; and
(7) resisting government intervention in market operations to the extent possible.

Subsequently, banks also acknowledge economic stratification of the society and entertain each individual with respect to how financially sound a person is; a wealthier person would likely to get more loan or financing as compared to a person who is lesser off. Dealing with the rich is profitable, whereas dealing with poor is not.

Banks also compete with each other in this context in a capitalist society, as banks also consider their ultimate objective to maximize their profitability for themselves and for their investors. Institutional structure of banks is designed to achieve these ends for themselves. Therefore, a modern bank, to compete and maximize its profitability (for itself and depositors) and the value of the shareholders, would eventually address and promote the following values:

- Mankind's ultimate end is to maximize his wealth, consumption and subsequent freedom.

المنارة للاستشارات

www.m

- It is justified to indebt oneself to acquire wealth, as this will enhance his potential to earn more, and pay it back in future.
- Saving and hoarding in a bank is good, profitable and less risky as compared to giving away as charity, buying real assets or investing in real business.
- More wealth is better than less wealth, and rich is better than poor.
- Honesty and integrity for borrowers is a required virtue, along with creditworthiness, to ensure safe return of principle with profit or interest.
- Competition is better than cooperation, as it is more profitable. Businesses borrow and invest in new product development to take the lead in the market as compared to their competitors. The successful ones would yield profit for the bank, whereas the failed ones would bankrupt and their collateral seized by the bank.

In context of Hollingsworth framework, this is the fifth level of institutional analysis. Tracing it back to the genealogical evolution of banking institution explains its historical causes. Ignoring its history would not allow the observer to understand why the institutional orientation of the bank is likewise.

The banks or financial institutions not abiding to these "interlocking" values would be left behind. A society where such a value system does not exists such as religious societies would not accept the banks or would adopt these values over a period of time by the influence of banking system, depending upon the political orientation of the society[7]. However, the degree of penetration of values stated above through these financial institutions would depend upon the degree of the strength of the traditional or native value system of the society where the banks would want to operate[8], in the context of Hollingsworth (2002) methodology institutional analysis as explained in the Introduction.

In a society where such banks, of conventional nature, are already operational, any new banking innovation, such as in the case of IBs, would eventually have to compete with conventional banks on the same lines, as otherwise, they would not be able to grow their market share. Furthermore, the structural arrangement of the banking institution would only allow innovation to an extent allowed by dominating values of the capitalist financial market. Perhaps, it is because of this reason that Mufti Muhammad Taqi Usmani has expressed concerns about the prevailing trends in the Islamic banking industry; here, he deserves to be quoted at some length:

> […] the trade-related instruments like murabahah, ijarah etc. used by them [IBs] in their operations, are not loans in strict terms, yet they create debts on the basis of deferred sales or renting […]. The idea was that after starting their operations on the basis of these instruments, they should gradually proceed towards the ideal forms of Islamic finance […]. Despite the differences […] between interest and these instruments, they have many similarities in the net result […]. This has prompted Islamic Financial Institutions to compete with their conventional counterparts in all respects, and restrict themselves to the debt-based products. In their zeal to compete conventional banks, they are trying to invent "shariah compliant" counterparts for each and every financial product available in conventional capitalist market, regardless of whether or not they are in consonance with the ethos of Islamic economy. Instead of gradual progress towards equity, the tendency is to make maximum compromises to accommodate debt- related products matching with practices of the conventional market. Even derivatives are being designed on the basis of "shariah compliant" methods. If some

المنارة للاستشارات
www.m

> products had to be equity based, they too were equated in some way or the other with a fixed return debt (Usmani, 2008).

In his article, Mufti Usmani could not explain why the Islamic financial institutions are following the band wagon of their conventional counterparts. It's not just him, various others, who expect the same from Islamic financial institutions are seemingly not aware of the exogenous and endogenous constraints which force the financial institutional framework to orient itself toward the normative premise for which it has been designed to conform. If this is true, then why would and how come the same framework can be expected to adopt *musharakah* and *mudarabah* as a preferred modes of finance and work in compliance with the ethos of Islamic Economics?

IBs and inflation

Mufti Muhammad Taqi Usmani has also assumed that the problem of "artificial […] money supply […] multiplied without creating real asset in the same quantity" (due to fractional reserve system) can be solved via Islamic banking because it is "[…] backed by asset, [therefore] it [money supply] is always matched with corresponding goods and services" (Usmani, 2005, pp. 21-2). It is claimed here that credit or debt creation done by Islamic banks is non-inflationary or will not inflate the money supply. This implies that there is nothing wrong with creating money supply out of thin air, and its ill-effects (if there are any) on the economy can be cured by IBs also operating on fractional reserve system when the money creation would be backed by real assets.

It is interesting to note that the same argument presented by Mufti Taqi Usmani of IBs being non-inflationary because of their asset-backed nature has also been presented for conventional banks. This is known as the "Real Bills Doctrine", which assumes that "inflationary over issue [of credit] is impossible provided money is issued on loans made to finance real transactions" (Humphrey, 1982, p. 4). This doctrine, although looks fine at theoretical level, however, looking more closely reveals various flaws in it which have been explained by Humphrey while referring to Henry Thornton (1760-1815), who was a British banker, a monetary theorist and a long-time member of the British Parliament. The three flaws are as follows:

Single asset, multiple exchanges. Any asset may exchange many hands, and during each transaction, a financial intermediary may create credit-money if required by the buyer of the asset; "Goods […] may be sold a number of times, each sale giving rise to a real bill" (Humphrey, 1982, p. 9). For example, in a supply chain, a product is transformed from raw material, to subcomponents, to finish good, then sold to whole seller, then to retailer and, finally, to the end user. At each stage, a financial intermediary may be asked to provide financing for purchases particularly in case of durable goods. IBs would use *murabaha*, *salam* or *istisna* instead, for that matter.

Cost of debt leading to more debt. The manufacturer after acquiring debt from a bank would add the debt servicing expense into the cost of goods, thus adding to the selling price. This would make inflation a "vicious circle", as Humphrey quotes Henry Thornton to explain his argument:

> […] forgot that there might be no bounds to the demand for paper; that the increasing quantity would contribute to the rise of commodities: and the rise of commodities require, and seem to justify, a still further increase.

المنارة للاستشارات
www.m

Continuous inflationary spiral. Finally, as a result of the above two, Humphrey explained, while referring to Thornton, that:

> […] the interest [profit in case of IBs] differential, if maintained indefinitely, produces a continuous and not merely a one-time rise in money and prices. This is so, he said, because as long as the differential persists, borrowing will continue to be profitable even at successively higher price levels. The result will be more borrowing, more lending, more monetary expansion, still higher prices and so on ad infinitum in a cumulative inflationary spiral.

For example, increased wages of the workers and debt servicing expense would further force the manufacturer to increase the price of his products, which would force workers to demand more wages and so on.

Therefore, keeping in view the arguments stated above, one can also expect contemporary IBs to be as inflationary as the conventional banks. This is due to their fractional reserve nature which makes them very similar to conventional banks, not in terms of nature of contracts, but in terms of the structure which enables them to expand the money supply just like conventional banks (Meera and Larbani, 2004; Zubair and Abbas, 1987, p. 4; Ahmed, 2006).

This suggests that even claiming to be asset-backed IBs (while maximizing profit, market share, share holder's value and competing with conventional banks on the same lines) would expand the money supply and generate a money multiplier effect and would subsequently contribute to inflating the money supply, at least in theory. In other words, inflationary effects of fractional reserve banking may not be curtailed by simply assuming that transactions in IBs generate real economic activity; this would continue to bring further disappointment to Mufti Taqi Usmani (d.b).

If esteemed Mufti Usmani (d.b) or someone from his team or other like-minded scholars had studied in detail the historical twists and turns through which the conventional banking framework has evolved, such an expectation would not have been disappointing them today.

Implications and conclusion

More details could have been provided about the historical evolution of the banking institutions, but that is not the purpose of this paper. The purpose was rather to propose a methodology of analysis through which the framework of banking needs to be analyzed. It is argued here that once such an analysis is done in depth and in necessary detail, keeping in view the genealogical history (see Table I for summary) and normative premise of the evolution of the respective institutions, it would be possible to holistically understand the potential of these institutions and to what extent they can be Islamized; some of the implications are explained below:

- Such an analysis reveals that banking framework may be expected to avoid modes of investment like *musharakah* and *mudarabah*, as depositors want their deposits safe. This, in turn, encourages the bank to invest them in less risky ventures and subsequently prefer debt-based products. *Musharakah* and *mudarabah*, therefore, require an institutional set-up very different from conventional banks!
- Rich depositors are preferred over poor ones, as dealing with them is relatively safe (only in theory though), because of which the concentration of wealth remains in the upper strata of the society. Goals like poverty eradication and equitable

المنارة للاستشارات
www.m

Level 1: Informal institutions	Liberal, secular worldview: ontological and cosmological views based on materialism, Scottish enlightenment, virtuous man: wealthy and powerful ones (see Adam Smith's "Theory of Moral Sentiments")
Level 2: Institutional arrangements	Liberal and secular state formation, social hierarchy based on aristocratic values, rich on the top, poor on the bottom, free competition in markets between rich and poor, social Darwinism
Level 3: Institutional sectors	Interest-based lending, monetary system based on bank notes representing credit or debt, corporate culture: profit-maximizing institutions (corporations) seeking loan to finance operations and expansion
Level 4: Concrete organizations	Private banks, central banks, insurance firms, corporations, cartels
Level 5: Output and performance	Consumerist culture, mass supply of debt, wealth and freedom and pleasure maximization for rich, increasing income disparity, industrialization of social functions (see Adam Curtis's documentary "The Century of Self" made for BBC)

Table I. Genealogy of financial institutions (capitalist) as per Hollingsworth framework

distribution of wealth are out of scope of the respective banking framework. What alternative mechanism would be required for that?

- The profit motive remains supreme, reinforced by the investors and depositors, which forces the bank to disseminate the same values to its clients; this is further intensified by the competition which exists in the market. Therefore, it is little surprising to see IBs advertising about dream cars and homes to attract and promote the consumerist mindset or love of wealth (which may also take one to hellfire as per Surah Takasur in Quran) in the name of competition and profitability[9]. What would then save the concerned from failure in *akhirah* then?

In this context, it is even more important to question the justification of putting a label of Islamic on the so-called IBs. If in its entirety, in terms of its design, internal and external constraints, embedded value system and influence on the society, an institutional framework does not completely fit in with the normative premise of Islam, then would it be appropriate to label it as Islamic only on the basis of Shariah-compliant contractual relationships? This question is raised because the term Islamic brings not just a set of contracts but also a complete belief system, worldview, value system, etc. which if not embedded, then it becomes questionable to label the respective framework as Islamic. In words of Choudhury (2008), the Western methods of finance and economics are so disconnected with the "*tawhidi* epistemological-ontological-ontic methodology" of Islam that it's not possible to align the two in any meaningful way. In the light of the metaphor explained in the Introduction, the tractor cannot be expected to perform the function of an ambulance when the objective is to provide comfort and save as much lives as possible. An alternative aligned with the objectives is what is required.

As emphasized in the beginning, the institutional framework is designed to achieve certain specific objectives with efficiency, and it is nevertheless unreasonable and unrealistic to expect the same framework to work for a distinct set of objectives. More specifically, a separate arrangement is needed to promote *musharakah* and *mudarabah*,

المنارة للاستشارات

www.m

for example, simply because the existing one is not designed to handle the risks and meet the necessary requirements.

Long-run monetary inflation also occurs because of constant expansion of money supply through the fractional reserve banking system, as theoretically proven in the Discussion. If this is assumed to be correct (although there are other natural or artificial causes to inflation as well), then one should not also assume that the framework of IBs are not guilty of causing any inflation at all, which, in the view of Meera and Larbani (2009), is equivalent to theft of purchasing power from the poor. Would "Full Reserve" IBs, acting more like mutual funds, avoid causing inflation as otherwise caused in a fractional reserve system? This needs to be explored in further research.

In a nutshell, when an institutional framework from the Western world is under consideration for adoption, to achieve the goals for which it was not originally been designed, an analysis at various levels proposed by Hollingsworth (2000) needs to be done, so that the concerned are aware in advance that which of the goals can and cannot be achieved efficiently and effectively with the said institutional framework.

Such an analysis would prevent the concerned to attach unrealistic and unreasonable expectations from an institution, or do necessary customization in the start, so that expectations are expected to be fulfilled. If the later is true, then colossal amount of time and energy spent to work out ways to bring alien institutions closer to the ethos of Islamic economy would be saved perhaps and would rather be spent on designing alternatives which may have the capacity to meet the expectations of Islamic scholars and academics, or ethos of Islamic economics, for that matter.

Notes

1. This is not a question of who works in the system of production and maintenance of tractors as outlined above, as no matter how good that person may be, he can perform as good as the respective system would allow him, for that matter. Metaphorically, this would mean that institutional framework might have some influence upon the individuals performing within it, i.e. no matter how pious Muslims they may be, they would be able to save the lives of patients to the extents the institutional framework allows them to.
2. It should be noted that the structural design or framework of the banking system is seen independently from its contractual relationship; these are the two separate, although interdependent, things; however, both have a unique set of abilities, strengths, weaknesses and influence over its stakeholders.
3. For instance, Abdul Kameel Maiden Meera, Mehmut Asutay, Javaid Akbar Ansari, Zahid Mughal, Habib-ur-Rehman, Muhammad Anwar, Masud Alam Chaugary, etc.
4. Capitalist society largely prefers *duniya* over *akhirah* and provides freedom proportional to the wealth a person has. Reisman has discussed this in great depth in his book "*Capitalism*", in which he has categorically mentioned religion and religious believes to be a barrier against developing a capitalist society.
5. This, in turn, would be used to purchase the very products they produced. This would generate sales for the same corporation who borrowed money to pay back the loan with interest it took from the bank.
6. As no matter how clean their past record may be, they are rational beings who prefer their own self-interest with that of others. Therefore, to protect their self-interest, financial

المنارة للاستشارات
www.m

institutions need to create policies and procedures to screen and monitor their clients before and after they take financial services from the bank, respectively.

7. It's a long history of how during the period of colonialism Western economic model was forcefully imposed in various parts of the world. The populations were economically deprived and were shown that the only way to survive was to accept the hegemony of the institutional framework designed to serve the interest of western powers.
8. For example, the total number of bank accounts in Pakistan till April 2012 were around 30.45 million (SBP, 2012), whereas the total population was 184 million as per Population Census Organization of Pakistan as on 18 October 2013 (available at: www.census.gov.pk for the latest number), which makes it around 16per cent of Pakistan's population if we assume that each individual has only one bank account, which is not the case. If we say that each individual has two bank accounts at least, then the percentage would be reduced by half to 8 per cent roughly. This implies that Pakistanis are not fond of using banking services in general.
9. Pious, God-fearing Muslims prefer not to dream about cars and homes, etc., rather fear their time in grave and accountability in *Akhirah* while dreaming about *Jannah* and pleasures awaited for them there if they keep their practices and beliefs as required by Islam. A Muslim society also inclines toward the same; is it not the responsibility of Islamic banks to do *dawah* to promote the same Islamic values, particularly when such values are on the decline in the society, or at least remain neutral about them, instead of doing something very opposite? But how would they compete and remain competitive on their balance sheets if they do not promote materialistic and consumerist values, or *takasur (see surah-e-takasur in Quran)*?

References

Ahmed, M. (2006), "Practice of Mudaraba and Musharaka in Islamic Banking", *Journal of Islamic Economics, Banking and Finance*, Vol. 2 No. 1, pp. 1-21.

Ansari, J.A. (2004), "Rejecting freedom and progress", *Jareedah*, Vol. 29 No. 1, pp. 47-224.

Bolles, A.S. (1892). *Practical Banking*, Homans Publishing Company, New York, NY.

Choudhury, M.A. (2008), "Islamic economics and finance: where do they stand?", *International Journal of Accounting and Finance*, Vol. 1 No. 2, pp. 149-167.

De Soto, J.H. (2009), *Money, Bank Credit and Economic Cycles*, Ludwig von Mises Institute, AL.

Hollingsworth, R. (2000), "Some reflections on how institutions influence style of innovation", *Review of International Political Economy*, Vol. 7 No. 4, pp. 595-644.

Humphrey, T. (1982), "The real bills doctrine", *Economic Review (Federal Reserve Bank of Richmond*), Vol. 68 No. 5, pp. 3-13.

Macleod, H.D. (1906), *The Theory and Practice of Banking*, 6th ed., Longmans, Green, London.

Meera, A.K. and Larbani, M. (2004), "The gold dinar: the next component in Islamic economics, banking and finance", *Review of Islamic Economics*, Vol. 8 No. 1, pp. 5-34.

Meera, A.K. and Larbani, M. (2009), "Ownership effects of fractional reserve banking: an Islamic perspective", *Humanomics*, Vol. 25 No. 2, pp. 101-116.

Rabb, T.K. (2006), *The Last Days of the Renaissance*, Basic Books, Cambridge.

Reisman, G. (1998), *Capitalism*, Jameson Books, Chicago, IL.

SBP (2012), "Statistical bulletin - April 2012: banking system", April, available at: www.sbp.org.pk/reports/stat_reviews/Bulletin/2012/Apr/BankingSystem.pdf (accessed 7 April 2012).

المنارة للاستشارات

www.m

Schumpeter, J.A. (2006), *History of Economic Analysis (reprint)*, Taylor & Francis e-Library, Great Britain.

SEP (2007), "Social institutions", 4 January, available at: Standford Encyclopedia of Philosophy: http://plato.stanford.edu/entries/social-institutions/ (accessed 6 July 2012).

Stephey, M.J. (2008), "A brief history of Bretton Wood System", *Time: Business & Money*, October, www.time.com/time/business/article/0,8599,1852254,00.html (accessed 13 March 2013).

Usmani, M.M. (2005), *An Introduction to Islamic Finance*, Maktaba Ma'ariful Qur'an, Karachi.

Usmani, M.M. (2008), "Looking for the new steps in Islamic finance", available at: www.muftitaqiusmani.com/images/stories/downloads/pdf/islamic%20finance%20-%20new%20steps.pdf (accessed 7 April 2012).

Veblen, T. (1912), *The Theory of the Leisure Class: An Economic Study of Institutions*, The Macmillan Company, New York, NY.

Wennerlind, C. (2012), "The alchemical roots of the financial revolution", 14 March, available at: www.berfrois.com/2012/03/carl-wennerlind-credit-alchemy (accessed 21 May 2012).

Zubair, I. and Abbas, M. (1987), *Islamic Banking*, International Monetary Fund, Washington, DC.

About the author

Omar Javaid has completed his MS in Islamic Finance and Economics from PAF-KIET and is a permanent faculty member at the same institute. He is also a founding member and Vice President of GEAR, a welfare organization providing Islamic microfinance to destitute families for their self-employment. He has also translated a book written by Mufti Dr Ismatullah Khan from Urdu to English, titled "*Money, Its forms and Usage: An Analysis in the light of Shariah*", published by Darul-Ishaat, Karachi, in April 2013. Omar Javaid can be contacted at: omar.javaid@criticmagazine.pk

For instructions on how to order reprints of this article, please visit our website:
www.emeraldgrouppublishing.com/licensing/reprints.htm
Or contact us for further details: **permissions@emeraldinsight.com**

المنارة للاستشارات

www.m

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

المنارة للاستشارات

www.manaraa.com