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Review

Role of central bank in a dual banking system and the regulatory challenges

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ABSTRACT

Traditionally, **c**entral bank as the apex bank of a country plays key role decision making and implementation of monetary policy in an economy. It formulates and ensures enforcement of government monetary policies as well as regulates, supervises and controls various activities of the commercial banks and monitors monetary development so as to ensure stability of the financial system. Also, it acts as Banker to the government and the commercial banks. But emergence of Islamic banking system in international financial arena poses great challenges to the role of central bank in both interest based traditional and interest-free Islamic financial systems, Hence, this paper intends to examine the functions of central bank by theoretically exploring and explaining how a central bank can adapt, adopt and modify the existing available tools in an interest based financial system in dealing with its regulatory, control and stabilization functions in an interest free Islamic banking framework operating in a dual banking system .

Keywords: Central banks, financial, Islamic banking framework, interest-based financial system.

INTRODUCTION

Central bank aside being governments' and commercial banks' banker has the mandate of ensuring financial stability in an economy. The general consensus among economists, as well as stakeholders is that it's the responsibility of the Central bank to guarantee the price stability in the medium term. The policymakers expect central bank to both observes and influence the policy decisions that affect the economy by regularly observing market activities for the purpose of assessing the state of the economy and as well decides the course of its policy. In essence, central bank primarily makes provisions for availability of sufficient reserves and monetary supply in order to avoid large fluctuation in price level and unemployment rate.

There are enormous studies conducted on central bank's various roles related to regulatory, supervisory, institutional and monetary aspects of conventional central banking. In contrast, the situation is not the same in the case of Islamic central banking framework. Therefore, there is a need to examine how central bank can efficiently perform its statutory obligations in an interest free banking system. This paper intends to deal with theoretical issues concerning how central bank functions in a dual banking system where both Islamic and conventional banks operate side by side. In essence, it explores the desirability, feasibility and necessity of central bank's new instruments of monetary control to mitigate conventional banks' problems that may occur in Islamic banks. It is argued by Hamid and Ahmad (1999) that although, there exist differences in their composition, contents and implications central bank in an Islamic banking framework can adopt and adapt almost all the available concepts in conventional framework, as it is possible in many cases that tools developed for one environment with minor effort can be modified for use in another environment.

In light of this, this paper explains the general function of central banks and examines how central bank can adopt, adapt and modify some of the available tools being used by conventional banking system to perform its mandatory functions in Islamic banking framework. This paper is divided into five sections. Section one introduces the concept of the paper. Section two reviews the literature. Section three discusses the functions of a central bank in Islamic financial system. Section four examines with regulation and legal control of Islamic banking institutions. Section five explores the instruments for regulating and controlling Islamic banks while section six concludes the paper.

Literature review

No doubt, central banking is unavoidable in the financial system of a country. Though, the general perception is that central bank is a pivotal mechanism of microeconomic stabilization but there is a wide divergence of opinions on its other supposed roles in the economy. The arguments over the functions of central bank stem from lack of universally agreed roles and comprehensive definition of central banks. While some studies simply define central bank as agent for monetary policy and bank of the banks, others like Toutouncian (2009) defines it as the "entity responsible for overseeing the monetary system for a nation". Borko and Mirjana (2010) define central bank as 'the central monetary institution that represents a bank of commercial banks and other financial institutions".

Furthermore, while Hamid and Ahmad (1993) stressed that central bank notably performs technical, administrative and other numerous function in the economy, Borko and Mirjana (2010) argued that central bank perform three primary functions which forms the bed rock of its respective operation and through which its wide scope of activities can be easily comprehend. The functions are monetary regulations, supervision of the financial system and Lender of Last Resort.

According to Goodhart (2010) the functional roles of central bank are (i) maintaining price stability which is subjected to the monetary regime in current operations, (ii) maintaining financial stability to foster broader financial development and (iii) supporting the State's financing needs at times of crisis and constraining misuse of state's financial powers in the normal times. Functions of central bank listed by Slideshare (2012) include: assistance in the conduct of monetary policy, supervision and regulation of financial institutions, government services, new currency issue, check clearing, Wire transfer services and research services.

However, Hamid and Ahmad (1999) argued that the most important of the long list of central bank's function is the provision of sufficient reserve to ensure adequate money supply. This helps in avoiding large fluctuation in price level and unemployment rate. They however, stressed that this requires central bank to keep the nominal output and employment rate very close otherwise central bank has to at least maintain the natural output rate while preserving the value of currency at a reasonable stable level.

This feat they argued can only be achieved through effective regulation and stringent control of the financial system by the central bank. Their argument is in line with the submission of Ausaf (2000) that to achieve the predetermined goals of a financial system the central bank must exercise control over commercial banks. This is because considering the importance of the commercial banks in the financial system and the risky nature of their operations coupled with ever increasing sophistication of the banking business, they cannot be left alone to go on their own ways but, he stressed that the control and regulation of the commercial banks has to take place within the overall financial policy framework.

Funstions of Islamic central bank in an economy

It is a common knowledge that conventional banking system is interest based which contradicts the Islamic laws and principles of business transactions. *Shari'ah* (Islamic law) upon which Islamic banking and finance is pivoted prohibits transactions that involve exchange of predetermined interest. A fixed return over and above the principal amount loaned in an Islamic contract is not allowed by *Shari'ah* (Khan, 1989). Considering the fact that Islamic banks in almost all countries practicing Islamic banking are operating under the conventionally oriented central banks, the bane of contention is answering the seemingly germane question of how would the policy makers and regulators regulate, supervise and control Islamic banking system which would be free of interest mechanisms?. Finding solution to this question becomes pertinent bearing in mind that interest prohibition in Islam is not based on certain economic theory but rather it is a fundamental principle of Islam which decrees charging interest as injustices.

Therefore, since the basis of Islamic transaction principles which is the source of recognition for Islamic financial system is based on elimination of *riba*, Khan (1989) suggested a special financial framework or policy that takes the unique nature of Islamic economy into consideration. In the same vain Choiruzzad (2012) stressed that apart from the *shari'ah* issue, the continuous growth and development of Islamic banking industry necessitates the needs for the specific entity that would deal with the affairs of Islamic banking.. His reason is premised around the fact that the recent development and innovation in Islamic banking industry had resulted in increased complexity in risk profile of Islamic banks for instance increased in profit sharing investment, fiduciary risk in managing customers' investment as well as risk of physical assets trading.

Hence, Salman (2010) emphasized a shift of attention to the regulator and supervisor (i.e. central bank) and the role and functions it supposes to perform in conformity with Islamic rules and principles and yet able to effectively perform its traditional functions of ensuring stability of the financial system through proper regulation, supervision and control.

Furthermore, Ausaf (2000) agreed that central banking that would perform the fundament functions of central banks is desirable in Islamic economic system but reiterated that such institution must work towards achievement of the goals of Islamic economy and in accordance with the *Shar'iah* laws and principles. According to Choiruzzal (2012) the central bank must play active role in ensuring that Islamic banks operate under a very conducive Islamic legal framework required to achieve the desired development of Islamic economy project. Also, Siddiqi (1986) submitted that Central bank overseeing Islamic financial system has to design rules that would protect all depositors' interest through proper diversification of investment and sale ratios between deposits and share capital. In the interest of the general public the central banks has to ensure proper and efficient management of commercial banks' funds and prevent overextension of credit in order to guide against bank runs and failures. It is the special responsibility of central bank to prevent bank runs and failures in the commercial banks by providing cushion effects to the banks as a Lender of Last Resort.

Hamid and Ahmad (1999) suggest a central bank that would work hand-in-hand with other authorities to ensure a balanced economic development, growth characterized by Islamic economic principles of social justice and equitable distribution of income and wealth. In addition the central bank should function as a state bank aiming at ensuring safeguard of the public interest and as well perform all the usual functions of the conventional central bank. As a state bank it would on behalf of government conducts both domestic and international transactions, responsible for issuance of currency and be a bankers' bank. Also, it important for the central bank to conduct state economic and monetary policies as well as monitoring the general drift in employment, business and changes in income and price levels in the economy with the intention to take the desirable and appropriate steps to promote them and maintain them at the required levels in order to have a stable financial system (Siddiqi, 1989).

However, Zeti (2009) recognized that to achieve financial system stability Islamic central bank has to come up with a more facilitative and modernized legal framework under which the commercial banks would operate. In Islamic financial system, the boundaries of such regulatory framework must be regularly improved in accordance with the evolution and transformation of the financial system. Still on achieving financial stability in Islamic financial system Zeti emphasized that the central bank has to embark on effective implementation and enforcement of the prudential and supervisory policy which would be reinforced by legal and *Shari'ah* framework. Contributing to the discussion on the subject Toutounchian and Harcourt (n.d) summarized the functions to be performed by central bank operating under *Shar'iah* laws and principles as follows:

- Active participation in preparation of economic development plan.
- Information dissemination about the priorities of investment projects outlined in the state economic development blueprint to the individual Islamic banks.
- Determination of Islamic banks' profit shares relative to those of the capital for different projects.
- Determination of the Islamic banks' value of risks involved in different projects and various sectors of the economy.
- Regular supervision and inspection of the Islamic banks to ensure that projects are properly finance relative to the priorities and the value of risk.
- Ensuring that Islamic banks concisely follow the regulatory and supervisory framework purposely developed for their hitch free operations.

However, Uzair (1978) supported the views of Siddiqi (1986) on the functions of Islamic central bank but pointed out that among the usual functions of the conventional central bank there are three main functions that will have to be restructured to be *shari'ah* compliant. These three main functions are the following:

i. Regulation and control of credit
ii. Lender of Last Resort to the Islamic banks
iii. Promotion and development of the banking industry

Supporting the view of Uzair, Seti (2009) opined that in carrying out these functions it is important for Islamic central bank to take into cognizance the basic legal, regulatory and supervisory framework that takes into consideration distinctive features and uniqueness of Islamic financial system. It should also try to put in place a comprehensive infrastructure to address the challenges facing international financial system in order for Islamic financial system to maintain its status as alternative to interest based financial system.

Regulation and legal control of Islamic banks

Islamic finance though a new phenomenon had come to stay and proved to be a viable alternative to the crisis ridden conventional financial system. The continuous and rapid growth of Islamic financial system had removed doubt over its viability and acceptability. Therefore, the concern is no longer about the stability of Islamic financial system but instead the current agitation is about the potential role of Islamic financial system in the greed and gambling cultured global financial system. This concern triggered the interests of those who are convinced of the benefits of Islamic finance over its innate tendency towards the stability of the global financial system which has to be bolstered by strong regulation and effective legal control.

On this note, Ausaf (2000) opined that for obvious reasons activities of commercial banks cannot be left uncontrolled and un-regulated. His opinion is based on the fact the position of commercial banks is strategic and precarious in the economy which makes them vulnerable to destabilizing factors in the economy if left uncontrolled and unregulated by the central bank of the country.

Nevertheless, there is a consensus among the studies establishing differences between the regulation and legal control of commercial banks in the pure Islamic financial system and mixed financial system. Despite the differences, majority of the studies on this subject agreed that the central bank in an Islamic economy is expected to perform the functions as the central bank in the traditional interest based economy.

Therefore, Islamic central bank is allowed access to some of the available traditional instruments being used by traditional central banks to regulate and control conventional commercial banks. This is allowed based on condition that those that involve interest among the instruments will be subject to modifications so as to make them *shari'ah* compliant. In alternative, Islamic scholars proposed that Islamic central bank should embark on devising new tools for the regulation and control of Islamic commercial banks or use some of the already available interest free instruments. This paper discusses some of the instruments.

Tools for regulation and legal control of Islamic commercial banks

Owing to the importance of commercial bank in ensuring the financial stability of a country it becomes imperative to ensure strong regulation and proper control of the commercial banks in the country. To effectively perform this function in a modern economy, central banks utilize a number of tools/instruments to exercise control over commercial banks. Such instruments mentioned by Ausaf (2000) include; Legal Reserve Ratio, Refinance Ratio, Open Market Operation, Credit Ceiling, Value Oriented Allocation of Credit, Lender of the Last Resort, Issue of Directives, Moral Suasion and so on. Hamid and Ahmad (1999) stressed that in Islamic finance framework a central bank can regulate and control Islamic banking using in its operation many of the concepts available for conventional central bank's operations. The interest free ones among these instruments which can be used by Islamic banks include the following:

Legal reserve ratio

Otherwise known as Required Reserve Ratio (RRR) refers to the percentage of the total deposit commercial banks are required to deposit with the central banks. This ratio of compulsory or required reserve to total deposits is a standard techniques used by the Apex bank for credit control and its form is usually determined by the central bank. Its inverse known as multiplier measures the capability of the commercial banks to create credit which is in multiple of the deposited amount. The central bank changes the monetary base and the value of monetary multiplier by varying the required reserve ratio. This also determines the availability of loanable funds in the commercial banks. Ausaf (2000) argued that central bank can use the Required Reserve Ratio as an instrument for regulating and controlling Islamic bank since it does not any form involve interest. But he clarifies that Required Reserve Ratio has to be redefined in accordance to the accounts operated by Islamic banks. However, some scholars oppose central bank using Required Reserve Ratio in Islamic economy. They argued that for Required Reserve Ratio to be allowed it must satisfy two conditions. First is that Required Reserve Ratio should be hundred percent (100%) while the second is that Required Reserve Ratio should be applicable to only demand deposits.

Refinance ratio

Manipulation of refinance ratio by the central bank determines the liquidity of the commercial banks. Siddiqi (1989) suggests using refinance ratio to regulate and control commercial banks operating in interest free basis. It can be used by central bank to control the creation of multiple deposits. Also, this instrument allows central bank to refinance some of the loans commercial banks grant to the public. Thus, it is used to encourage commercial banks to give out more loans especially *Qard Hassan* to the customers. Central bank does this by manipulating percentage of refinancing it offers the commercial banks upward or downward which determines the capacity and willingness to give loans to the public.

Moral suasion

This is refers to informal interaction that takes place between central bank officials and those of the commercial banks through which central bank elucidates its policies to the commercial banks or encourages them to achieve desirable goals. This conventional method of persuading commercial banks can be a very useful instrument which Islamic central bank can employ in interest free financial system to control Islamic banks in implementing formulated policies in true spirit. In fact opinion of the Islamic scholars is that it is more desirable in interest free banking system than the conventional counterpart.

Lender of last resort

This refers to an institution usually the central bank of a country that bails out commercial banks by means of loans provision to the banks or other financial institutions undergoing financial difficulty or considered highly risky or at the verge of collapse. The function of central bank as Lender of Last Resort enables it to protect individual depositor as well as to prevent panic withdrawal from commercial banks having liquidity problem. However, the loans are usually granted on interest in an interest based financial system. The consensus of the Islamic scholar is that this function can also be performed by Islamic central bank by granting interest free loans (*Qard Hasan*) which may attract or may not service charges.

Profit sharing ratio

This technique could be used by central banks in Islamic economy to regulate commercial banks in place of bank rate. It is a tool of credit control available to Islamic central through which money supply and economy activity level is governed via profit sharing between Islamic banks and their depositors on one hand and the bank and the client on the other (Kahf, 1978). This enables the central bank to regulate depositors' share ratio and investments' share ratio. The former determines the supply of money while the latter influences the demand for money which in turn determines the volume of investment in the economy.

Uzair (1978) argued in favour of profit sharing ratio as a tool of money management and banks' control in an interest free economy and tried to establish it feasibility and desirability. This notwithstanding some Islamic economists notably Chapra (1982) disagreed with the usage of profit sharing ratio as a tool of monetary policy. Instead, he preferred the negotiating parties to determine the ratio according to their perception of market condition and profitability.

CONCLUSION

The concept of interest receives great attention in the neoclassical economic theory. This constitutes the major difference between Islamic finance and the conventional financial system. The major aspiration of a central bank is to affect the market rates of interest using a number of instruments that determine the supply of money in the economy such as open market operation, bank rate, changing required reserve ratio and so on. Therefore, problems of central bank in Islamic banking system are almost the same with those faced by the central bank in the conventional counterpart. Although, the central bank essentially has to ensure economic stability in a country, it is responsible for mitigation current or perceived financial crises. Therefore, central bank regulating controlling Islamic banks has to design and implement plans to address the problems such as interest rate, financial instability, inefficiency of banking institution etc. using the available instruments. In the attempt to explain the general functions of central bank in a financial system, the manner in which central bank can perform its function in an equity based Islamic banking framework is explored and explicitly explained. The necessary simple modifications to the current conventional instruments were suggested and discussed on theoretical basis.

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