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Interest-Based Banking Model: Historical Development and Inception of Islamic Banks

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ABSTRACT

Banking institutions have become integral to an economy by supplying credit and other financial services to existing markets. The concept of central banking emerged to regulate banking activities and control them through a sound supervisory framework. In recent days, a central bank has been responsible for regulating the monetary and credit systems of a country. Muslim society has been conducting its economic activities through money and dealing with some banking-type activities since its inception. Thus, it is worth exploring and reviewing the historical development of the interest-based banking model to understand the dynamics of conventional banking in depth and to propose alternate modes of Islamic finance. Islamic banking has experienced tremendous growth in recent decades, with diversified services for retail and corporate customers. Yet, until now, we knew less about the topic from a historical perspective. Therefore, this paper aims to review the literature about the interest-based banking model over time and the modern practices of Islamic banks all over the globe. Banking institutions are playing an important role in attaining economic growth and stable markets. Concerned central banks are recommended to provide a supportive environment to banking institutions and welcome Islamic banks for financial inclusion in Muslim-majority territories.

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1 Introduction

In modern days, banks play a central role in financial intermediation for people with excess funds and entrepreneurs facing a shortage of funds in the economy. A sound banking

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system for fund mobilization is necessary to accumulate growth of a country. Banks supply credit to industry for investment which generates employment and commodities to meet the needs of society in local and international markets. This international interaction appreciates domestic currency and improves the balance of payments. Indeed, the development of banking institutions leads to economic prosperity and development. Although, today's banking has been completely changed as compared to yesterday's banking activities. Currently, smart technology, artificial intelligence, digital banking, and mobile interactions have affected the sources of interactions between financial institutions and consumers. Banking has also expanded to the retail, investment, corporate, and microfinancing sectors of the economy. Every country has a regulatory framework to supervise the banking industry through central banks. In the modern world, the Bank for International Settlements (BIS) is the central bank of all central banks of member countries to develop a homogeneous system for global financial stability and to bring cooperation among members.

The interest-based banking model is as old as the medieval Roman empire and it has been found in different shapes over the ages. Notably, modern banking institutes have been started to fuel the capitalistic industry in the 17th century. These banking institutions borrow the funds at the liability side with a relatively low interest rate and lend to the industry relatively higher rate of interest. In such a way they earn the interest spread of borrowing and lending rates through playing the role of financial intermediation. The existing wide range of conventional interest-based products are designed based on interest which is nullified by Allah Almighty because of social injustice and economic disorder. However, Islamic banking is a financing activity in line with Islamic principles. Accordingly, there is a set of Islamic financial modes that persists of Murabah'ah (Cost-plus), Mudarab'ah & Musharak'ah (Partnership based contracts), Ijar'ah (Lease), Salam & Istisn'ah (Sale-based Contracts) (Shah & Rashid, 2018). As complementary to Islamic business law, Shari'ah prohibits any type of interest on credit dealings.

An essential set of instructions include that investment must be done in Halal commodities, whereas any business against Islamic instructions on pork, porn, or alcohol, is declared Haram. The same principles of Halal and Haram also work in the services sector of daily routine matters (Shah & Irfan, 2022). Further, El-Gamal (2001) has elaborated an applied aspect of the games of chance and Al-Gharar (Uncertainty) and declared them invalid in some cases and void in some other cases from the sayings of Holy Messenger (PBUH). According to Ernst & Young's most recent Islamic Banking Competitiveness Report (2017), the global demand for Sharia-compliant services and goods has led to a significant expansion of the Islamic financial market during the previous ten years. The capital of Islamic banks increased from $200 billion to an astounding $3 trillion between 2000 and 2016, and it is predicted to reach $ 7 trillion by the beginning of 2025. The Islamic financial industry is growing rapidly, which is forcing conventional financial institutions to provide Sharia-compliant services to the market. As per the report of the Islamic Financial Services Industry Stability Report, (2017), the Islamic banking industry continued to lead with assets of USD 2.25 trillion. In terms of regions, GCC led all others with a 53.6 % share of the total industry. In particular, there are indications that the number of people using Islamic products in non-Muslim majority nations is still growing in the Islamic banking sector.

The importance of the banking sector as a financial intermediation between excess and shortage of funding invites us to investigate about existing banking model from the perspective of its historical development. Similarly, we also intend to know about the origin of central banking as regulator and supervisor of the banking sector. As a Muslim individual, an increase in Islamic banking share is also a source of encouragement as an alternate interest-free model. Yet, we have not found a single paper in afore aforementioned contexts of the interest-based banking model and the inception of Islamic banking. This research would be equally important for academicians, practitioners, and Shari'ah scholars to understand the essence of banking operations.

There are seven sections in the manuscript. Introducing in 1st section, we have reviewed the literature on the historical development of interest-based banking models and the establishment of central banking in 2nd and 3rd section, respectively. We have presented the functions of central banks in the 4th section. Then, sections 05 and 06 explain the arrival of banks to Muslim communities and Islamic banking as alternate models, respectively. Finally, section 07 concludes the manuscript.

2 Historical Development of Interest-Based Banking Model

The name "bank" mimics the fact that banks first appeared in temples. According to the New Testament, Christ flipped over the money changers' tables as he threw them out of the Jerusalem temple who were dealing in the dominant currencies. Similar to this, the bankers in Greece were referred to as trapezia, a title that came from the tables at which they conducted business. Similarly, the Italian banca is where the English word "bank" originates, and it refers to a bench or counter. In Italy, banking had sprung back up along with the revival of the arts and commerce. From an alternative viewpoint, the word "bank" originates from the Italian word "banco," which refers to a bench and is connected to the Jews of Lombardy, an area located in Northern Italy. In the past, the Jews had held the benches in the market where cash and bills were exchanged. The public would protest and break a banker's bench if he failed, and this is how the name "bankrupt" originated in the meaning of default (Russell, 2011).

The origins of banking can be traced to the first banks, established by merchants who lent grain to traders and farmers in different places. The ancient civilizations of Sumeria and Assyria began this practice circa 2000 BC. In the ancient Near East and the Levant, Assyria was a prominent Mesopotamian monarchy and empire that began as the Assur city-state in the 25th century BC and ended in collapse between 612 and 609 BC. In a similar vein, Sumer, which flourished during the Chalcolithic and Early Bronze periods in what is now southern Iraq, is the oldest civilization known to have existed in the historical region. Interestingly, Sumer predated both Ancient Egypt and the Indus Valley by approximately 5500 and 4000 BC, respectively. Afterward, under the Roman Empire and in ancient Greece, loans were provided by lenders housed in temples. The foundation of these operations was the receipt of change and deposits. Currently, historically, loan practices are likewise present in ancient China and India.

Mediaeval and Renaissance Italy; the rich cities of Florence, Venice, and Genoa in particular have been recognized for having a significant influence on the historical evolution of the banking system. They provided the basis for the banking model in a way suitable to the requirements of their time. The Bardi and Peruzzi families established the banks' subsidiaries in several other European nations, so controlling the growth of banking in Florence during the fourteenth century (Hoggson, 1926). Similarly, in 1397 the Medici Bank; the most famous Italian bank was established by Giovanni Medici (Goldthwaite, 1995). Since 1472, Banca Monte dei Paschi di Siena is the oldest bank in Siena, Italy, and existing yet (Boland, 2009).

In the fifteenth and sixteenth centuries, we see the growth of banking organizations extended from northern Italy to the Holy Roman Empire and over northern Europe. Several financial establishments in Amsterdam during the Dutch Republic in the 17th century came before it. In a similar vein, London has had banking since the 18th century. During the 17th century, basic banking activities started in different regions. These functions include deposit collection, money changing, financing activities, moneylending, and transferring funds, and further these are related to the issuance of bank debt. This innovation appeared as an alternative to gold and silver coins and fostered industrial growth by providing a safe means of payment and discounting the debt for the business. In the last quarter of the 17th century, the banking sector appeared as an important source of financing for the operations of the combative European states. This emerging role of the banking sector led to the need for government regulations to manage their activities and to protect the users' rights. Hence, there emerged the concept of central banks very 1st time. Moreover, there appeared aggressively the new banking strategies and practices in Amsterdam and London. There also appeared a source of confidence elsewhere in Europe.

3 Establishment of Central Banking

After its founding in 1609, the Bank of Amsterdam served as a template central bank for how one should operate while handling currency exchange. The central bank industry developed by adhering to this concept. Though it only existed for a brief period, the Sveriges Riksbank was another early central bank, having been founded in 1668. Quinn and Roberds (2005) have outlined a model for the Bank of Amsterdam; the first true central bank. They have employed a modified model of money and payments in line with the Freeman and Gelernter (1996) model. First, they analyzed thoroughly the challenging monetary situation and the ways of exchange in the Netherlands before the establishment of the Bank. Finally, they have described the model of how a central Bank could meet the situation by performing its commercial obligations.

In England, in the 1690s, the supply of public funds was very low, but the government needed to accumulate funds to sponsor the ongoing clash with France. The government of William III was not able to borrow the £1,200,000 at 8 % because of low credit in London. The government attracted the subscribers for loan by using the name of the Governor and the company of the Bank of England. These names are selected to get the confidence of subscribers in the market. In the end, however, the bank was granted complete control over the government's balances and designated as a limited liability company with the only ability to print banknotes (Bagehot, 1873). Similarly, the lenders were supposed to give cash to the government, and they were also authorized to issue the notes against the security of the government bonds, the same were also allowed that be lent again. Only in 12 days, the £1.2M was raised and the Navy was rebuilt through half of this amount. In 1694, Charles Montagu, 1st Earl of Halifax devised the model of central banking for the Bank of England. Although three years ago William Paterson had proposed the same model, the model was not implemented. Even, current global banking is based upon the same philosophy of central banking (Macmillan-Report, 1931). It was proposed that the central bank will collect a loan worth £1.2 Million for the government. In this process, the Governor and Company of the Bank of England would be a guarantor for the fundamental rights of the subscribers incurring in the process of this deal. This central banking system provided confidence with banking privileges over the long term including the issuance of notes. On legal grounds, the Royal Charter was issued on the 27th of July 1694 via the Tonnage Act 1694 (Roseveare, 2014).

Initially, observe that the Bank of England was originally a private institution, but it was converted to a public authority to maintain a sound financial system by the end of the 18th century. The central bank faced the currency crisis of 1797, and it stopped the government from converting the notes into specie payments as depositors were withdrawing the amount from the central bank. Despite all the crises, the central bank was given the status of an organ of the state for its next operations. Accordingly, different authorities and responsibilities were given in the mandate of the central bank. In addition, Henry Thornton had worked as a monetary theorist and merchant banker. He holds the status of the founder of the modern system of central banking. Moreover, he was against the real bills doctrine and supported the bullionist position. Further, he endorsed the earlier theories of Knut Wicksell in the domain of the process of monetary expansion about the cumulative process that elaborates the Quantity Theory of money theoretically in its coherent form.

In 1802, Thornton wrote a book "An Enquiry into the Nature and Effects of the Paper Credit of Great Britain" in response to the 1797 currency crisis. He had documented that an increase in paper credit never appeared to be a cause of the crisis. He has recommended the

Bank of England the ways to strengthen the value of the pound and the British monetary system as well (Beaugrand, 1981).

The Bank Charter Act of 1844 restricted all commercial banks and provisional banking companies from issuing their banknotes. The Bank of England was authorized to print currency notes as a monopolist. Further, there was an interesting aspect of the Bank of England, when it accepted the title of “the lender of last resort”. It happened as it was criticized due to its discouraging response to the crisis of Overend-Gurney in 1870. Walter Bagehot; the journalist had analyzed the matter of Lombard Street in a handful of ways. He supported the agenda of making the central bank officially the lender of last resort in a description of the money market during the period of credit crunch. Due to his contribution, this is referred to as "Bagehot's dictum".

Following the Bank of England, European countries started establishing central banks during the 19th century. In 1800, there occurred the War of the Second Coalition in France. These days, the Banque de France started its operation as the central bank of France, especially to finance the war through public funds. The US Congress passed the Federal Reserve Act in 1913, establishing the US Federal Reserve to oversee the nation's payments and credit system. Australia became the first country to create a central bank in 1920; Colombia followed suit in 1923; Mexico and Chile followed suit in 1925; and Canada and New Zealand followed suit in 1934. Brazil was the only independent country that had not established its central bank for a long time, then Brazil founded the central bank in 1945.

After independence from the colonial system of British and France, African and Asian countries also came forward to establish their central banks or monetary union. In Pakistan, the State Bank of Pakistan (SBP) was established immediately after independence. SBP commenced operations on July 1, 1948, after the ordinance was put into effect in June of that same year. In Malaysia, Bank Negara Malaysia is the central bank which started operations on 26 January 1959. In recent years, the Bank for International Settlement has endorsed a harmonized system to remove the discrepancies in the global banking market.

4 Functions of Central Banks

In 1695, the Bank of England issued the permanent banknotes in 1695. At first, the bank committed to pay the banknote bearer upon demand. These handwritten banknotes were printed with or without a deposit and were distributed. Later, the standardized notes were printed for the public and announced publicly ranging from £20 to £1,000 in 1745, then the signature of a cashier appeared on a banknote in 1855 (Roseveare, 2014). The 18th century appeared with a wide range of banking services including cheques, clearing facilities, overdraft protections, credit arrangements, and security investments. Originally, these cheques were initiated in the 1600s, and banks themselves were supposed to settle the payments by direct arrangements to the issuing bank in England. Then, they started settling at central markets in 1770, and by the 1800s a banker’s clearing house was found to facilitate the users of these cheques. The London clearing house developed a mechanism of clearing accounts where the accounts of each participant were settled down before the day. In 1728, the very first overdraft facility was initiated by the Royal Bank of Scotland (RBS) to facilitate the public (McDiarmid, 2021).

During the Industrial Revolution, factors of mobility, innovations, and international trade affected positively the growth of banks in London. Innovative financial products increased the scope of the banking industry with time. Similarly, merchant-banking families started issuing credit to the public through banks. Further, they started dealing in everything from underwriting of bonds to initiating loans from abroad. As a result, the merchant banks led to economic growth, international trade growth, profiting from seaborne shipping of England. In banking history, there are two prominent immigrant families, the Rothschilds and Baring. To improve commercial lines, merchant banking firms were developed in London in the late 18th century. Through inventive facilities, they took over the global banking industry in the following century. In 1797, a great push appeared in the banking history of the Bank of England, when England was threatened by the Battle of Fishguard by Revolutionary France, and cash payments were suspended by the Bank of England. Due to the panic of this incident, the English Parliament authorized the Bank of England and other bankers of the country to issue notes of low denomination.

In the case of Japan, Ohnuki (2007) narrated that the Meiji government attempted to formulate a modern banking system in line with French models very 1st time in 1868, which continued until 1881. They imported the minting machines from Britain and established the Imperial minting department. Later banking advancement was led by Masayoshi Matsukata as a formative figure in the banking history of Japan. In 1930, the BIS was initiated by an intergovernmental agreement among European countries, Japan, and the United States of America. BIS conducts meetings, programs, conferences, and research symposiums to ensure the Basel Process for global financial stability. It also delivers a variety of banking services at different levels, but only to central banks.

A central bank's modern duties include overseeing the nation's credit and monetary systems. It also entails ensuring price stability and a sound monetary system in the economy and maximizing the use of a nation's economic resources to promote the expansion of the credit system in the best interests of the country. Additionally, it aims to attain monetary stability by monitoring the government's inflation policy objectives (Shah, 2018b). Additionally, it seeks to provide financial stability through the payments system's and financial markets' effective operation. Mishkin (1996) has documented that price and financial stability guarantee continuous economic growth.

5 Inceptions of Commercial Banks in the Islamic World

The Islamic world has been passed through different ages with diversified governance styles in different continents. However, Shari'ah (Islamic law) prevailed in the general public, including to make the financial matters free from interest. Most of the Muslim states were converted as colonies of British and French empires. They introduced reforms to different aspects of existing Muslim and other communities. The economic system was not an exception in the agenda of these masters in which they implemented capitalism with the complete essence of self-orientation. In the supervision of central banks, banking branches were established in colonies. Commercial banks were introduced in Islamic countries when they were in the transitory phase of political and economic downfall in the late 19th century. In the context of this political scenario, the main banks of these imperial powers opened their local branches in the big cities of these countries. These banks primarily served foreigners' needs for international commerce facilitation. As a result, the local citizens were unaware of the modern banking system. However, it became difficult to deal with international business partners without banking services with time (Hassan et al., 2021). Technically, this model of commercial banking was against the essence of Islam as there are offered deposit interest rates and charged lending interest on the liability and asset side of the balance sheet, respectively. In this financial intermediation environment, many committed Muslims appeared interest-sensitive and they confined themselves to limited banking activities such as current accounts for the sake of protection and money transfers as a facility (Kabir et al., 2022).

Kuran (2004) has explored that during the tenth century, Islamic law provided solutions to credit shortage and supported interest-free credit and investment instruments. These were similar to advances prevailing in the non-Islamic world, but before the 19th century, there was not a single financial institute recognized as a bank in the Muslim world. Until 1920, there was not emerged the first Muslim majority-owned bank. After independence from the United Kingdom and France, different Muslim countries appeared on the global map and they started following the same rulers in the establishment of all systems, including the banking sector. Over time this adoption continued in the supervision of central banks of concerned countries.

In the 21st century, a revolution in telecommunications and computing brought a big change in operations. There has been an increase in the size of the industry and spread geographically through financial liberalization (Rashid et al., 2020; Shah & Bano, 2021). The recent financial crisis of 2007–2008 hit many banks badly affecting some of the largest banks in the world and started a debate about monetary policy actions and banks' regulation. Bourkhis and Nabi (2013) have noted that the global financial crisis has beaten the conventional banking sector badly, whereas Islamic banks survived during this bitter position. This success has increased interest in the Islamic banking business model. Moreover, Muslim individuals are interest-sensitive due to declaring war against Allah Almighty and Holy Prophet PBUH, therefore they rush away from the conventional banking system to interest-free Islamic financing models as retail and corporate customers.

6 An Initiative of Islamic Banks in the Banking Industry

The international Islamic banking and financial sector has grown quickly in a variety of markets and, by picking up speed, has spread into new areas. The concepts of Islamic economic thoughts have been institutionalized in a few decades in Islamic countries. Interestingly, Islamic financial products are being developed at a large scale as alternatives to interest-based products, which fulfill consumer and corporate needs for funds. Similarly, the Shari'ah governance framework, Shari'ah compliance auditing practices, Islamic codes of ethics, and Islamic accounting techniques are developing parallel to the product's arrival. Islamic banking is working in compliance with Islamic economic theories with a sound Shari'ah governance framework. On the balance sheets of Islamic banks, we see alternate contractual relations are there to comply with Islamic law of business contracts. Depository accounts are managed based on Modarbah contacts, where depositors provide funds as Rab ul Maal (owners of capital) and Islamic banks work as Modarib (Investment skill providers). All depositors pool financial capital in Modarbah pools and profit is assigned by Islamic banks to the participants in each pool as per the agreed ratio of net profit reflected in the income statement. Equity is managed based on Moshark'ah as a participatory contract with different proportions of capital participation. On the left side, assets are managed based on Murabh'ah, Ijarah, Diminishing Mushark'ah, Salam, Istisn'ah, and other Islamic financial contracts (Shah, 2018a). These factors depict the positive fortune of the Islamic banking industry in Muslim countries and other countries with major Muslim populations.

The global Islamic financial services industry (IFSI) showed stability and resilience while navigating the still volatile global financial environment. It also witnessed structural development (IFSB, 2017). In Table 1 we see that IFSI consists of banks, sukuk, Islamic funds, and Takaful institutions. The Islamic banking industry continued to lead with assets of USD 2.25 trillion. In 2nd place, we observe Sukuk with a 23.3 % share of total IFSI, which impressive share in recent development and performance of these capital market instruments. In terms of regions, GCC led all others with a 53.6 % share of the total industry (IFSB, 2017). These statistics of IFSI are good indicators of achieving the sustainable goals the United Nations intended to achieve in 2030.

The development of the Islamic banking industry needs parallel support of Islamic monetary instruments and Islamic capital markets to manage the newly emerging industry and economy as well. Countries like Sudan and Iran have replaced completely Sharia-compliant banking systems and have discarded interest-based banking. Similarly, some other countries are facing the monopolistic status of the Islamic banking industry, such as Malaysia, Brunei, Jordan, Indonesia, Bangladesh, Kuwait, Pakistan, and the United Arab Emirates are examples of dual banking system economies (Shah & Bano, 2021). In this regard, Brunei, Bahrain, Indonesia, Sudan, Malaysia, Pakistan, and UAE have already initiated some Islamic monetary instruments to accommodate the emerging system of Islamic finance, this is done as a first step in this direction of the development of the Islamic financial market. Likewise, sukuk are increasing with a dominant base to these monetary instruments. However, the structure of Sukuk is combined through a variety of contracts for the same product which opens a door of controversies among Islamic scholars. The majority of them declared that such monetary products are not Shari'ah compliant and these Sukuk are yet to be refined (Mansoori, 2010).

Figure 1
Global Islamic Finance Industry In 2022 (USD Billion)

Region	Islamic Banking Assets	Ṣukūk Outstanding	Islamic Funds Assets	Takāful Contributions	Total	Share (%)
Gulf Cooperation Council (GCC)	1342.9	356.6	24.1	16.7	1740.4	53.6%
South-East Asia (SEA)	307.2	411.4	32.8	6.0	757.4	23.3%
Middle East and South Asia (MESA)	478.3	57.8	62.9	5.9	604.9	18.6%
Africa	49.6	2.9	1.9	0.8	55.2	1.7%
Others	71.2	1.0	14.9	0.6	87.7	2.7%
Total	2249.2	829.7	136.6	30.0	3245.5	100.0%
Share %	69.3%	25.6%	4.2%	0.9%	100%	

Source: IFSB Secretariat workings

In their investigation into how central banks carry out their mandates, Choudhry and Mirakhor (1997) found that the majority of them use moral suasion as an additional weapon to complement other available market policy tools. Because it can be challenging to weigh the benefits and drawbacks of moral persuasion, academics and practitioners disagree over its application. The strategy of moral suasion may take many forms in the economy from persuasion to directives. It is strongly recommended to use the option of moral suasion rarely, to make an effective monetary policy with complements of Islamic financing industry. Otherwise, there may be monetary policy puzzles (Rashid et al., 2020; Shah & Irfan, 2022; Shah & Rashid, 2019). These growth trends in the Islamic financial industry will accelerate the financial inclusion of Muslim-majority developing countries with a positive impact on capital formation among them. Overall, it will eradicate poverty and lead these nations to the growth of the economy.

7 Conclusions and Recommendations

Banks play an important role in financial intermediation to allocate funds efficiently and effectively in an economy. They collect amounts from small saving units for interest to be paid to savers with a smaller digit and finance big business units for interest to be collected from them with a bigger digit. The spread between both interest rates appears as a share of the bank. We have analyzed the historical development of the interest-based banking model, central banking, its functions, its arrival in Muslim countries, and the inception of Islamic banks as an alternate model. Overall, we found that the importance of banks can never be denied due to their important role in accumulating business activities and economic growth. However, we can change the contractual obligations of participants in line with the guiding principles of Islamic financial law. This historical review of the interest-based model facilitates researchers to understand the dynamics of conventional banking in-depth and move to propose alternate modes of Islamic finance. Interestingly, the capital of Islamic banks moved upward from $200 billion to $3 trillion and it is predicted to touch $ 6 trillion by early 2025.

We recommend central banks with major Muslim populations get lessons from the historical development of the interest-based banking model and move to develop an alternate Islamic bank model. With Shari'ah-based proposals, Islamic banks can contribute to capital formation and fuel economic growth as the objective of Shari'ah. This is the right time for central banks to consider the Islamic banks of the Islamic financial industry as a complement to any type of policy stance. As a future research agenda, comparative differences in the composition of assets and liabilities can be explored between conventional and Islamic banks as a reflection of their conceptual models.

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