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THE ROLE OF THE CENTRAL BANK AND THE SHARIAH BOARD IN REGULATING AND SUPERVISING THE ACTIVITIES OF ISLAMIC BANKING

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ABSTRACT

The purpose of the research - The article examines the regulatory tools and control mechanism of the central bank in Islamic banking. For this purpose, Islamic banking and finance instruments, their characteristics and central bank regulatory tools in the traditional system are explained. On the other hand, in Islamic banking, the central bank's alternative monetary policy instruments and regulatory mechanism have been studied. The aim of the study is to assess the alternative approach to the central bank's monetary policy instruments, regulation and control mechanism.

Research methodology - Analysis, comparison, grouping and generalization methods were used during the research. The research methodology is to study the existing theoretical approaches in this area and create an alternative mechanism. For this purpose, the central bank's monetary policy instruments in both traditional banking and Islamic banking have been studied.

Significance of the application of research - The rapid development of Islamic banking in the world makes it even more necessary to study its regulatory mechanism and solve problems. Another importance of the application of the research is to increase the financial literacy of the central bank in Islamic banking on the instruments of control and regulation.

Results of the research - The research examined the central bank's regulatory mechanism in Islamic banking models, the Shariah Board and its relationship with the central bank, and the central bank's alternative monetary policy instruments.

Originality and scientific novelty of the research - The scientific novelty of the research is the assessment of the existing alternative regulatory-supervisory mechanism of the central bank in the regulation of Islamic banking and the provision of additional recommendations.

INTRODUCTION

Islamic banking has been developing rapidly in the world since the middle of the 20th century. This development makes it necessary to regulate them. For this purpose, Islamic financial instruments, its categories, Islamic banking models, central bank regulatory instruments in the traditional system and central bank regulatory instruments in the interest-free economic system are explained. In particular, the problem of using the same policy in the regulation of Islamic banks operating in the traditional banking system is becoming more urgent. To this end, central banks have begun to use alternative monetary policy instruments and interest-free financial instruments. In this study, we studied the experience of countries around the world and alternative monetary policy instruments of the central bank to solve the problem. At the same time, the role of the Shariah Board in the regulation of Islamic banks and its relationship with the central bank were studied. The purpose of the study is to assess the central bank's alternative monetary policy and control mechanism in the Islamic banking model, increase financial literacy in this area and provide additional recommendations.

THE ROLE AND FUNCTIONS OF THE CENTRAL BANK IN THE TRADITIONAL BANKING SYSTEM

The current traditional banking system is rooted in Western culture, Christian-Jewish tradition, Roman law, and Greek thought. The West's views on private property cannot be made without reference to Roman law. While economics used to be the subject of ethica science, it formed the theoretical basis of capitalism after the industrial revolution. [15]

In current banking system banks are intermediary financial institutions. Banks are financial institutions that accept deposits and make loans. Banks are the largest financial intermediaries in economy. A bank is a financial institution that trades money. It borrow and keeps on behalf of his clients their money (savings), lending money (interest based on lending) and provides different financial services (checks, credit cards, transfer, exchange and so on). There are several kinds of banks. Generally the term "bank" includes commercial banks whose role is limited in accepting deposits and finance companies by interest based on loans. [16]

Money creation process and monetary policy usually is made by central banks. Received deposits by banks always have not lent out are called reserves. Some reserves are held in the vaults of commercial banks. In our hypothetical economy, all deposits are held as reserves: banks simply accept deposits, place the money in reserve, and leave the money there until the depositor makes a withdrawal or writes a check against the balance. This banking system is called 100-percent reserve banking. If banks hold 100 percent of deposits in reserve, the banking system does not affect the supply of money.

But as long as the amount of new deposits approximately equals the amount of withdrawals, a bank need not keep all its deposits in reserve. Thus, bankers have an incentive to make loans. When they do so, we have fractional-reserve banking, a system under which banks keep only a fraction of their deposits in reserve. Thus, in a system of fractional-reserve banking, banks create money. This process of money creation can continue forever, but it does not create an infinite amount of money.

Note that although the system of fractional-reserve banking creates money, it does not create wealth. When a bank loans out some of its reserves, it gives borrowers the ability to make transactions and therefore increases the supply of money. The borrowers are also undertaking a debt obligation to the bank, however, so the loan does not make them wealthier. In other words, the creation of money by the banking system increases the economy's liquidity, not its wealth. [17]

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[15] Ahmet Tabakoghlu, 2008, Introduction to Islamic Economics, 2nd edition, October, Istanbul, 545 pages, pages 35-36

[16] Mishkin Frederic S, The economics of money, banking, and financial markets, Seventh Edition, 2004, Columbia University, 679 pages, p.8

[17] N. Gregory Mankiw, Macroeconomics, Eighth Edition, Harvard University, 2013, 625 pages, page 88-90

The goals of the central bank are:

a. full employment
b. Balanced economic growth
c. Improving the balance of payment (BOP)
d. price stability

The three main functions of the central bank are as follows.

- Implementation of money policy
  - Open market operations
  - Last resort loans
  - Required reserve ratio
- To provide payment services for banks and other financial institutions accepting deposits
  - Supervising and regulating banks
  - Organization of lending
  - Organization of deposit services
  - Transfer and payment services
  - Currency transactions
- To act as the bank of the state
  - Regulating and supervising the activities of banks
  - Execution of the state budget account
  - Purchase and sale of government securities
  - Establish relationships with foreign central banks
  - Control over foreign exchange reserves and their purchase and sale and etc. [18]

For instance, The Federal Reserve System (Fed) is the central bank of the USA. A central bank is a bank's bank and a public authority that regulates a nation's depository institutions and conducts monetary policy, which means that it adjusts the quantity of money in circulation and influences interest rates.

A central bank influences the quantity of money and interest rates by adjusting the quantity of reserves available to the banks and the reserves the banks must hold. To do this, a central bank manipulates three tools:

- Open market operations
- Last resort loans / Lending to Banks
- Required reserve ratio / Reserve Requirements

An open market operation is the purchase or sale of securities by the central bank in the loanable funds market.

A central bank is also the lender of last resort, which means that if a bank is short of reserves, it can borrow from the central bank. But central bank sets the interest rate on last resort loans and this interest rate is called the discount rate.

[18] Yahya Abdul-Rahman,The Art of Islamic Banking and Finance (Tools, Techniques for Community-Based Banking), Translators. Prof. Dr. Salih Tug, Dr. M.Abdullah Tug, Istanbul Zaim University, 2nd edition, Istanbul, 2017, 774 pages, pages 222-223

The required reserve ratio is the minimum percentage of deposits that depository institutions are required to hold as reserves.[19]

Central bank performs five general functions to promote the effective operation of the economy

- conducts the nation's monetary policy
- promotes the stability of the financial system
- promotes the safety and soundness of individual financial institutions fosters payment and settlement system safety and efficiency promotes
- consumer protection and community development [20]

As a result central banks affect money supply by various tools-open-market operations, lending to banks, reserve requirements and interest on reserves. In this process all central banks in the world serves as the nation's central bank.

- The first central bank oversee the banking system.
- The second It regulates the quantity of money in the economy

BASIC PRINCIPLES AND MAIN FINANCIAL INSTRUMENTS IN ISLAMIC BANKING

Islamic banking and Islamic finance are distinct from conventional banking and finance. They are based on compliance with Shariah Law. Islamic banking are largely merchant and investment banking oriented. They typically relate to or involve the real economy, especially trade and investment. [21] [i]

The basic principles of Islamic finance are as follows.

- Money is not a commodity and it supports the growth of wealth by helping a purchasing power.
- Prohibition of Usury/Riba
- Prohibition of speculation/Bay'ul-qarar
- Prohibition of Uncertainty/No element of gambling
- Unauthorized activities (unlawful, unethical or immoral transactions)
- Distribution of risks
- Disclosure of information on banking activities to partners [22] [ii]

Financial instruments in Islamic finance and banking can be grouped as follows.[23] [iii]

- Debt-based finance instruments

a) Benevolent Loan/Interest-free loan/Charity loan/Qurud hasanah
b) Interest-free loan based deposit

- Investment and partnership-based finance instruments

a) Mudarabah/Trustee Partnership Facility/ Passive partnership
b) Musharaka/Joint Venture Facility/Active partnership/ Partnership financing
c) Diminishing Musharakah/Co-ownership

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[19] Michael Parkin, Macroeconomics, Tenth Edıtıon, 2012, 452 pages, p.190-192

[20] Federal Reserve System Publication, The Fed Explained What the Central Bank Does, Eleventh Edition, August 2021, 131 pages, page. 2 (https://www.federalreserve.gov/aboutthefed/files/the-fed-explained.pdf)

[21] Inwon Song and Carel Oosthuizen, IMF Working Paper, Islamic Banking Regulation and Supervision: Survey Results and Challenges, WP/14/220, 42 pages, page.6

[22] Hussein Tunch, Participatory banking: philosophy, theory and application of Turkey, 8th edition, Istanbul, 2010, 298 pages, p.122-126

[23] Loannis Akkizidis, Sunil Kumar Khandelwal, Financial risk managment for islamic banking and finance, 2011, 220 pages

- Sale-based and Leasing finance instruments

a) Murabaha/Cost-Plus Sale/ Mark up
b) Finance Leasing
c) Operating Leasing
d) Tavarruq/Commodity Murabaha
e) Istisna/Deferred payment and deferred delivery/Order to sale
f) Salam/Hire-Purchase/Order to construct

- Service-based instruments

a. Takaful (Islamic insurance/Mutual insurance)
b. Sukuk (interest-free security)

İntermediation of Islamic financial institutions, including the function of banking, is different from that of conventional financial institutions. This difference is the key to understanding the difference in the nature of risks in conventional and Islamic banking. Mudarabah intsrument is the cornerstone of financial intermediation and thus of banking. In a mudarabah the owner of capital forms a partnership with an entrepreneur or manager who has certain business skills, and both agree to share the profits and losses of the venture undertaken. By this finance instrument can be applied by an Islamic bank to raise funds in the form of deposits as well as to deploy funds on the assets side. Mudarabah is a "labor-investment partnership" established on the condition that the investment is on the one hand. Mudarabah is based largely on the profit-and-loss sharing (PLS) mode.

TABLE № 1. Theoretical Balance Sheet of an Islamic Bank: Based Functionality, Sources and Application of Funds [24]

Assets (Application of funding)	Liabilities and equity (Sources of funding)
Cash balances	Demand deposits (amanah)
Short-term trade finance (murabahah, salaam)	Investment deposits (mudarabah)
Medium-term investment (ijarah, istisnah)	Investment deposits (musharakah) /
Long-term Investment assets (mudarabah, musharakah)	İnvestment deposits (mudarabah)
Interest-free loan (Qard Hasanah)	General investment deposits
Interest-free loan based deposit	Special investment deposits (mudarabah, musharakah)
Fee-based services (Takaful, Sukuk)	Equity capital and shareholders' reserves
Non-banking assets	Equity capital

The second partnership-based financial instrument is a Musharakah. Musharakah is an active partnership in which both investment and labor are actively promoted. In Mudaraba, if the financial loss belongs to the investor (rabbul-mal), it is divided according to the investment ratios in the joint venture.[25]

Musharakah, is a combining the act of investment and management. In the absence of debt security, the Shariah encourages this form of financing. The Shariah is fairly comprehensive in defining different types of partnerships, in identifying the rights and obligations of the partners, and in stipulating the rules governing the sharing of profits and losses.

[24] Hennie van Greuning and Zamir Iqbal, Risk Analysis for Islamic Banks, The World Bank, 2008, 336 pages, p. 18, 19,21
[25] Cihangir Akin, Interest Free Banking and Development, Istanbul-1986, 440 pages, p.149

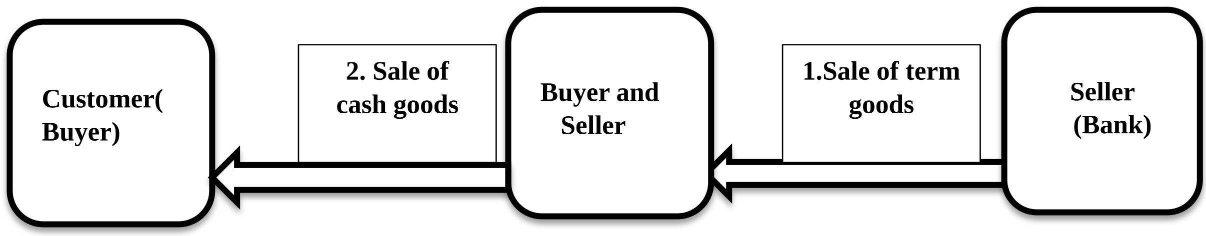
Murabahah, a cost-plus instrument is one of the most popular agreement for purchasing commodities and other products on credit. The financier and the entrepreneur agree on a profit margin, often referred to as markup, which is added to the cost of the product. The payment is delayed for a specified period of time during which the entrepreneur produces the final product and sells it in the market.

Investing instruments are vehicles for capital investment in the form of a partnership. There are two types of investing instruments: fund/money management (mudarabah) and equity partnerships (musharakah).

Investment account holders are investors or depositors who enter into a mudarabah contract with the bank, where investors act as the supplier of funds (rab al-mal) to be invested by the bank on their behalf, as the agent (mudarib). The investors share in the profits accruing to the bank's investments on the assets side. Therefore, such profit-sharing investment deposits are not liabilities. Investors' capital is not guaranteed, and they incur losses if the bank does; the form is closer to that of a limited-term, non-voting equity or a trust arrangement.[26]

A transaction is a temporary purchase and sale of goods for cash. The main purpose of this financial instrument is to meet the needs of people with cash shortages/liquidity. The goods put up for sale through this transaction are bought by the buyer for a period of time and sold for cash to another buyer. This operation is the exact opposite of the Murabahah tool, which is a temporary sale of goods.

SCHEME № 2. Tavarruq financing[27]



The liabilities side of Islamic banks' balance sheets generally consists of two types of deposits in addition to shareholders' equity:

- Investment deposits: These are mobilised on the basis of profit-and-loss sharing (PLS) as well as the different salesbased modes of *murabahah, ijarah, istisna* and *salam* on the assets' side. Even the sales-based modes involve some risk, though not as much as the PLS modes. This participation of investment depositors in the risks of banking is unique to Islamic banking. However, the risks can, and should, be minimized through a proper management of banks in a suitable regulatory and supervisory framework.
- Demand deposits: These do not participate in profit and loss and, being in the nature of debts owed by banks, their repayment must be fully guaranteed.[28] [iv]

Demand deposits is placed as amanah (demand deposits): they yield no returns and are repayable on demand and at par value; therefore,money creation through the multiplier effect is limited.[29] [v]

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[26] Hennie van Greuning and Zamir Iqbal, Risk Analysis for Islamic Banks, The World Bank, 2008, 336 pages, p.20, 21, 24

[27] Ishak Emin Aktepe, Participation finance, TKBB publications, Publication No: 9, 2017, 268 pages, p.117

[28] Umer Chapra M. and Tariqullah Khan, IDB-IRTI, Regulation And Supervision of Islamic Banks, Jeddah - Saudı Arabıa, 2000, 105 pages, p.11

Islamic economists ideally want to have only investment deposits on the liability side and on the asset side only profit-sharing contracts. Islamic banks have current account and investment deposits on the liabilities side and on the asset side they have several profit-sharing variants of products such as *Musharakah*, *Mudarabah*, *Murabaha*, *Istisna*, *Salam*, and *Ijarah.*

The fundamental difference between Islamic banking and conventional banking arises due to the prohibition of *Riba*. The interest-free current accounts are distinguished from the investment deposits. The asset side of the Islamic bank comprises of funds which are held with the Central Bank and other financial institutions, property and other assets, along with *Murabaha*, *Mudarabah*, *Ijarah,* and other financing. The liability side largely consists of depositor funds. Islamic banks have to follow certain rules regarding the maintenance of the accounts. First, each project should be financed and recorded through a special project account which can specifically record and report the transactions related to the project.[30]

SHARIAH BOARD AND CENTRAL BANK'S REGULATORY FRAMEWORK IN ISLAMIC BANKING MODELS

There are three widespread Islamic banking model as following.

Explicit Recognition of Islamic Banking. In This model it is indicated that the legal and regulatory framework explicitly recognizes Islamic banking practices, products or institutions;

Conduct of Islamic Banking by a Stand-Alone Islamic Bank. This model indicate that Islamic banking was being conducted by a stand-alone Islamic bank

Practice of Islamic Banking by Conventional Banks. Third model indicate that Islamic banking was being conducted by a conventional bank.

The effective prudential regulation and supervision of banks is necessary in Islamic banking as it is in conventional banking. The risks of Islamic banking are those typical of financial intermediation. The objectives of applying prudential regulation and supervision to Islamic financial activities are the same as the case of conventional banks. For instance, to pursue and maintain financial stability by ensuring the safety and soundness of banks, preventing problems from having systemic reflection. An important objectives are the regulatory framework for Islamic banking and the stability of the financial system. Key elements include:

- understanding the nature of Islamic banking activities,
- making regulatory framework for Islamic banking,
- leveling the playing field between Islamic banking and conventional banking.

There are four approaches to regulatory framework for Islamic banking

1) Single Regulatory Framework for applied to all banks (with no reference to Islamic banking); These countries include Saudi Arabia, South Africa, U.A.E., and the U.K
2) Single Regulatory Framework with References Applying to Islamic banks; (with references identifying provisions applying specifically only to Islamic banking and banks); Jordan, Kazakhstan, Qatar, and Turkey
3) Separate Regulatory Framework for Islamic Banks / two separate independent regulatory frameworks (one for Islamic banking and another for conventional banking); Bahrain, Iraq, and Kuwait

[29] Hennie van Greuning and Zamir Iqbal, Risk Analysis for Islamic Banks, The World Bank, 2008, 336 pages, p.20

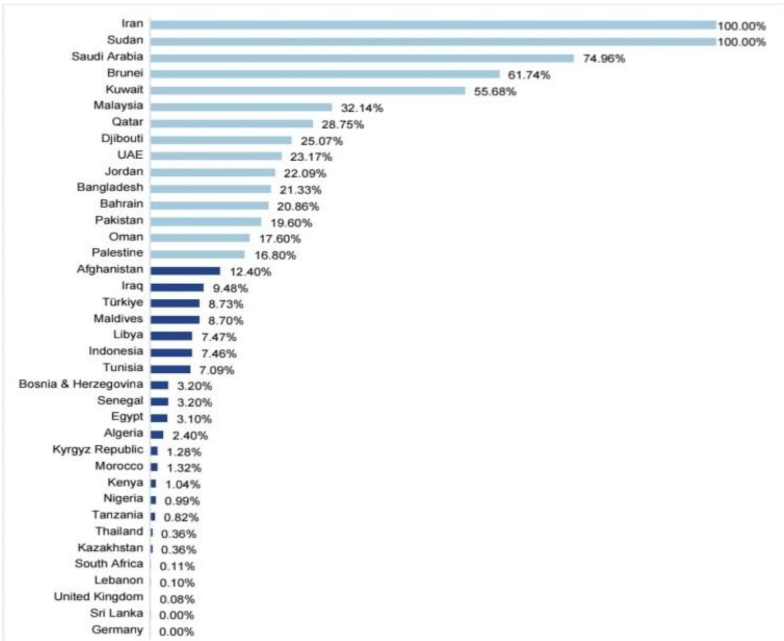
[30] Loannis Akkizidis, Sunil Kumar Khandelwal, Financial risk managment for islamic banking and finance, 2011, 220 pages, 9-10

4) Mixed Approach / Single Regulatory Framework with Separate Guidelines/Regulations for Islamic banks) (a similar regulatory framework is adopted for areas that are applicable to Islamic and conventional banks, but separate guidelines and regulations are issued for areas that are specific to Islamic banking); Indonesia, Lebanon, Malaysia, and Syria [31] [vi]

Islamic banks represent the majority of Islamic financial institutions. Islamic banks and central banks relations can be distinguished in three cases. Firstly, Islamic banks are accommodated with the framework if the existing bankin laws. This is the case with Islamic banks operating in Western Europe. Secondly, there are countries where special laws have been enacted allowing Islamic banks to function. Jordan, Egypt, Turkey, Bahreyn, Malaysia and other countries include in this category. However this legislation is mostly confined to the working of only a few Islamic financial institions where the bulk of the money market is still controlled by conventional financial institutions. Thirdly there are some countries where a comprehensive legal framework has been created for the Islamic banking system. Pakistan, Iran and Sudan includ in this category. Islamic banking in Iran, Pakistan, and Sudan, all commercial banks were transformed to comply with Shariah rules and principles.

Licensing procedures are as necessary in an Islamic banking framework as in conventional banking. There are different licensing requirements to establish Islamic banks in practice. These procedures help supervisory authorities to ensure that new banks are managed in a sound manner. There are issue of Different type of licenses for Islamic banks: a stand-alone an Islamic banking license and a single (generic) banking license is issued to a bank, irrespective of whether the bank is an Islamic or a conventional bank. [32]

TABLE № 3. Islamic Banking Share in Total Banking Assets (2023) [33]



31 Inwon Song and Carel Oosthuizen, IMF Working Paper, Islamic Banking Regulation and Supervision: Survey Results and Challenges, WP/14/220, 42 pages, page.9, 11,13-14

32 Ausaf Ahmad, Research Division, IDB-IRTI, Instruments of regulation and control of Islamic banks, Jeddah, 2000, 51 pages, p.11,15

33 Islamic Financial Services Industry Stability Report, 2024, 122 pages, p.28, https://www.ifsb.org/wp-content/uploads/2024/09/IFSB-Stability-Report-2024-8.pdf

Islamic banking also has a key feature that distinguishes it from traditional banking. This distinctive feature is the existence of a Shariah Board, a separate structural unit, to control the quality of services in those banks or banks. These staffs are an integral part of Islamic banks. These councils include the opinions of scholars and other expert members. The Shariah Board clarifies whether Islamic banking products and new operations are Shariah-compliant. The Shariah Board is responsible for overseeing and inspecting the application of religious law to financial institutions. The primary responsibilities and powers of the Shariah Board include:

- Development of new operations and services
- Supporting the bank's management to launch new services
- Provide analysis of the religious compatibility of contracts, services and transactions
- Inform the public about the services provided to customers by traditional banks and financial institutions under the name of interest-free.

In the Malaysian practice, the National Shariah Board of Islamic Banking of Malaysia operates in a separate section of the Islamic Banking Department of the Central Bank (Bank Negara Malaysia, BNM), which is part of the country's central bank, the Bank of Negara Malaysia. This Board makes fatwa-type decisions in the field of various banking services, products and operating standards. The decisions made by the Board are made by all interest-free banks. On the other hand, interest-free banks also establish a Shariah Board. This approach also has the function of resolving disputes between the Board of the country's central bank and the bank's Board. [34] [vii]

Shariah Board-Central Bank-Islamic banks relations. Regulatory frameworks typically do not prescribe distinct and separate corporate governance frameworks applicable only to Islamic banks. Shariah Board is main role in İslamic banking regulation and supervision. Conventional regulatory frameworks typically do not prescribe distinct. Shariah Board has the ultimate responsibility and authority in advising on Shariah matters. As well The Shariah Board have to establish in both the central bank and the Islamic bank.

The central bank has a Shariah Board. Shariah Boards of central banks differ in their mandate, scope, governance, and accountability. There are different models on the role of a central bank's Shariah Board. In some cases the central bank's Shariah Board has overall authority over Shariah issues that relate to banking and finance. It is the final arbiter in disputes on such issues. Thus, this central bank's Shariah Board has legislative and adjudicative powers. (e.g., Malaysia and Sudan). In other jurisdictions the central bank's Shariah Board does not have legislative or adjudicative powers in relation to Shariah law. (e.g., Afghanistan, Pakistan, and Syria).

A majority of jurisdictions require Islamic banks to have a Shariah Board. In jurisdictions where there are no Shariah Board (the supervisory authorities) it would consider a possible case of mis-selling Islamic financial products. (e.g., Kenya, Tunisia, and Turkey).

The function and role of ensuring Shariah compliance within an Islamic bank is usually conducted by internal auditors or Shariah auditors. In specific jurisdictions including banking and financial legislation, an Islamic bank's internal auditor has a statutory responsibility to ensure

[34] Yahya Abdul-Rahman,The Art of Islamic Banking and Finance (Tools, Techniques for Community-Based Banking), Translators. Prof. Dr. Salih Tug, Dr. M.Abdullah Tug, Istanbul Zaim University, 2nd edition, Istanbul, 2017, 774 pages, pages 199-203

Shariah compliance by the Islamic bank. (e.g., Iran, Pakistan, Saudi Arabia, and Sudan). In other jurisdictions, an Islamic bank is required to have a dedicated Shariah auditor.[35]

TABLE № 4. Existance of Shariah Board in Islamic Bank [36]

	Islamic Banking Model	Existance of Shariah Board
Bahrain	Dual banking system	Each Islamic bank must have a Shariah Board
Indonesia	Islamic windows allowed, Active Shariah bank development strategy in place by the government	Separate Shariah Board required
Iran	Single (Islamic) banking system	No Shariah Board for individual banks, Onsite and offsite supervisory methods and objectives defined and applied
Jordan	Dual banking system	Separate Shariah Board required
Kuwait	Dual banking system	Separate Shariah Board for each bank necessary
Malaysia	Dual banking system	Separate Shariah Boards at institutional level in the Central Bank and Securities Exchange Commission
Pakistan	Major financial transformation is called for by the Supreme Court of Pakistan to introduce Islamic banking and financial system	Shariah Board concept does not exist
Qatar	Dual banking system	Separate Shariah Boards for banks required
Sudan	Single (Islamic) Banking system	Separate Shariah Boards for banks required, also the Central Bank has a Shariah Supervisory Board
Turkey	Dual banking system	Onsite and offsite supervision concepts and methods exist
UAE	Dual banking system	Separate Shariah Boards required
Yemen	Dual banking system	Separate Shariah Board required

CENTRAL BANK'S MONEY POLICY IN ISLAMIC BANKING

There are different approaches for supervision and regulation of Islamic banking. In Islamic banking, the central bank's monetary policy and banking regulation mechanism differ from convertional banking. Uzair thinks promotion of interest banking and conversion of interest based banks to interest free financial institutions would be one of the prime functions of an İslamic central bank. It can be perform this function by providing commercial banks with financial, technical and personnel assistance. [37]

It is known that there are three ways to expand the monetary base. Emission of money, creation of bank money and surplus in the balance of payments. The first and second of these are implemented through the central bank.

[35] Inwon Song and Carel Oosthuizen, IMF Working Paper, Islamic Banking Regulation and Supervision: Survey Results and Challenges, WP/14/220, 42 pages, page.16-18

[36] Umer Chapra M.and Tariqullah Khan, IDB-IRTI, 2000, Regulation And Supervision of Islamic Banks, Jeddah - Saudı Arabıa, 105 pages, p.27-29

[37] Ausaf Ahmad, Research Division, IDB-IRTI, Instruments of regulation and control of Islamic banks, Jeddah, 2000, 51 pages, p.15

The majority of Muslim economists are in favor of 100% reserve in the interest-free economic system. (Sıddıqı). The arguments of this view are as follows.

a) Ensuring stability. Fractional-reserve banking system is the main reason for the instability in the money system.

b) Maintaining real balances at low cost. The increase in the supply of money as a result of money creation and either deposit or cash substitution will increase the cost of maintaining fundamental balances.

c) Ensuring justice. It is unfair to authorize banks to create loans. Because banks that benefit from these transactions will make excessive profits with these funds, which they have seized at a low interest rate. However, the benefit of creating money should be appropriated to the society. That is why 100-percent reserve banking provides its at the best.

The arguments of the second approch/fractional-reserve banking are as follows. According to this approach, credit money is not a factor of instability. It is not true that only banks benefit from the bank money creation process. On the other hand, the benefit of banks in this transaction is not the result of the fractional-reserve banking It is impossible to apply the 100-percent reserve banking without nationalizing the banking system. (Necar, Sıddıqı, Chapra).

Since there is no interest in the Islamic banking model, interest rates are affected by the profit margin instrument instead of the interest rate instrument. To do this, the central bank and the bank with the depositor and bank set the ratios for participation in the profit.

In Islamic banking, the Central Bank acts as a lender of last resort and can be issued in the form of interest-free loans (qard-al hasan) when lending to banks through a refinancing instrument in traditional banking. Through this tool, the central bank influences the liquidity of the financial system and banks.[38]

Another financial instrument is the liquidity ratios, which affect the reserves of the banks. banks are obliged by the central bank with this tool, to store a certain amount of money they can give in credit, in cash or in the form of a bank. Central bank's "ceiling policy" can be used to extend the investment and debt obligations of banks.

Another monetary policy instrument is to direct a portion of time deposits to government projects with high social benefits. On the one hand, this will be an additional support for the central bank's emmission, as well as a risk for banks, as it is guaranteed by the state.

Public share of demand deposits is an entirely new tool for the central bank control over commercial banks. It has been suggested by Chapra who has proposed that a certain proportion of demand deposits of commercial banks.

The credit ceiling is another non-interest method in the interest-free banking system.

The central bank also functions as the lender of the resort to commercial banks if any commercial bank faces a liquidity problem and is short of cash, the central ban may bail it out by providing it with an appropriate loan. In an interest based economy, such loans are provided on the basis of interest. In an Islamic economy the central bank could perform this function either by providing an interest-free loan (Qard Hasan) with or without a service charge.

[38] Cihangir Akin, Interest Free Banking and Development, Istanbul-1986, 440 pages, p.91

It is generally known that quantitative methods of credit control are designed to control the volume of credit while the purpose of selective methods of credit control is to influence the direction of credit. Several methods of selective control suggested by Muslim economists can be listed here.

Refinance scheme. Under this scheme the central bank first identifies the priority sectors and then extends special matching credit to those commercial banks which have extended finance to the weaknest sectors. In the interest based system the central bank extends matching credit at al lower rate of interest. Under the interest-free system matching credit would be offered either as an interest free loan (Qard hasan) or on the basis of profit sharing. If it is offered on the basis of profit sharing, the central bank would share in the profit with commercial banks when they offer finance with the help of central bank funds. In order to kae it concessionary and the encourage further financing in the priority sectors the central bank may itself opt for a lower profit sharing ratio.

Other Selective credit control method is determining the minimum and maximum profit sharing margin requirements. Fixing a minimum and/or maximum ratio of profit for Islamic banks in their Musharaka and *Mudarabah* activities.[39]

In Islamic financial markets, banks use the Mudarabah Interbank Investment and Interbank Tavarruq/Commodity Murabaha and Wakalah Investment instruments to meet liquidity needs. Wakalah is a relationship between principal and agent. When a person appoints someone else as his agent, he uses wakalah.[40]

In Islamic economics, the most important function of the money is that it is a medium of exchange. In general, Islam considers the main goal of ensuring price stability, which is an element of monetary policy, to prevent uncertainties, money savings and speculative transactions, and, as a result, to ensure a fair distribution of income. [41]

On the issue of credit, the importance of implementing an expanding credit policy in this area is emphasized. Prohibition of bay'ul-qarar/speculation weakens speculative tendencies in the credit system.

Interest rates are the most important factor guiding capitalist monetary policy. Interest rates play the most important role in monetary policy in the modern economic system. Changing these rates gives direction to politics. In Islamic economics, income rates are used instead of interest rates. Therefore, changing interest rates is not considered a monetary policy tool. Prohibition of interest is important to eliminate uncertainty, exploitation and injustice.

Islamic states have adopted a natural increase in the money supply as a policy. The Seljuk Empire and Ottoman Empire encouraged the entry of gold and silver into the country, and banned its exit. Ottoman Empire also accepted the principle that a foreign merchant who brought goods into the country should return with the goods.

By changing of participation rates in profit on the Mudaraba instrument and required reserve ratio can be money policy instrument in İslam economy. In open market operations, stock

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[39] Ausaf Ahmad, Research Division, IDB-IRTI, Instruments of regulation and control of Islamic banks, Jeddah, 2000, 51 pages, p. 24,27,28,29

[40] Dr. Servet Bayindir, Islamic Finance in Fiqh and Economics –II (Money and Capital Markets), Suleymaniye Foundation, First Edition, July 2015, Turkey, İstanbul, 272 pages, p.245

[41] Money, interest and Islam. Islamic Science Research Foundation. Istanbul, 1992, 235 pages, p.80

documents, profit partnership and income partnership securities, etc. can be used. Through this method, the central bank regulates the supply of credit. An interest rate ban ensures good results by minimizing speculative tendencies.[42]

CONCLUSION

The study concludes that Islamic banking's rapid growth requires central banks to revise their regulatory and supervisory approaches. Unlike conventional banking, Islamic finance operates on profit-and-loss sharing principles, demanding Shariah-compliant monetary tools and oversight. The role of Shariah Boards is vital for ensuring transparency, compliance, and system stability. We can summarize the results in article as follows.

- We believe that it is expedient to set required reserve ratio in accordance with the risks of the sectors.
- The second proposal is to apply this limit only to demand deposits in banks that meet certain standards.
- The third proposal is that the participation of the Sharia Committee in the creation of new types of operations and services is essential.
- In economy policy, the tools for using income rates instead of interest rates should be expanded.
- Central bank have to demand from commercial bank having Separate Shariah Boards required.
- Central bank have to change monetar policy intruments for development of Islamic banking sector.
- Institutionalization of Shariah Supervision – The establishment of an independent Shariah Board should be a mandatory requirement for every commercial bank to ensure consistent supervision and compliance.
- Development of a National Islamic Banking Model – Countries like Azerbaijan should develop a national Islamic banking framework that clearly defines the roles of the central bank, Shariah Boards, and commercial banks within a unified legal and institutional structure.
- Expansion of the Central Bank's Regulatory Mandate – Monetary policy instruments should be designed based on profit ratios and return-sharing mechanisms instead of interest rate benchmarks.
- Introduction of New Monetary Instruments – The central bank should utilize Shariah-compliant open market instruments such as sukuk and profit-partnership certificates to conduct liquidity management.
- Enhancing Financial Literacy – Comprehensive training programs for central bank officials and financial sector professionals should be implemented, alongside public awareness campaigns to improve understanding of Islamic financial principles.

[42] Islamic Science Research Foundation, Money, İnterest and Islam, Istanbul, 1992, 235 pages, page. 80-81,83,86-87

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