

Are Checking Accounts in American Banks Permissible Under Islamic Laws? A Note

by
Ali F. Darrat*

The purpose of this note is to stimulate the thought of Muslim scholars about a neglected aspect of American banking business, namely the payment of interest on demand deposits (checking accounts).

Demand deposits represent funds that commercial banks use to extend loans to the public and purchase interest-bearing securities. The revenues from these activities are a major source of income for commercial banks. Consequently, fierce competition exists among banks to attract such funds. However, competition for these funds, until recently, could not take the form of an explicit interest rate because the American banking laws prohibit the payments of explicit interest rates on demand deposits. Existing laws have relaxed this prohibition for some forms of demand deposits (e.g. Negotiable Orders of Withdrawals, NOW accounts), though the prohibition still holds in the case of what is commonly called in the banking jargon *regular* checking accounts, i.e., checking accounts that do not explicitly yield interest to the holders.

Because of the intensity of competition among commercial banks to attract public deposits, and in the presence of the legal prohibition against explicit interest payments on regular checking accounts, banks have devised alternative outlets to compete for the checking accounts funds. Perhaps the most obvious alternative is for a bank to reduce (or remit) charges to depositors for the use of bank payments services below the cost to the bank of providing those services. Others take the form of, for example, providing a wide range of cash management services at very nominal fees and occasional gifts. In economic literature, these are called *implicit* interest rates, and many recent empirical studies have established the fact that commercial banks in the U.S. do in fact pay high implicit interest rates on non-interest bearing demand deposits of approximately equal value to the rate which would be explicitly paid in the absence of the legal prohibition.¹

*Ali F. Darrat is Assistant Professor of Economics at the University of Kentucky.

¹See, for example, Klein (1978), Startz (1979) and Rush (1980).

Of course, according to the Glorious Qur'an and the authentic Sunnah, (the two fundamental sources of Islamic Laws) usury is unequivocally forbidden (for example, II: 275, and III: 130). There is also a general consensus among Muslim scholars that banks' interest payments are usurious and thus forbidden under the Islamic laws.² The issue here is whether explicit *as well as implicit* interest rates are usurious. Most Islamic discussion in academic and public circles alike focus on the Islamic prohibition of *explicit* interest rates that banks in western (and many Muslim) countries provide on banking saving accounts, with the implication that a Muslim can deposit his/her funds in checking accounts since such accounts do not yield (explicit) interest rates. But, as we argued above, these checking accounts also yield interest rates, albeit implicit (or in kind).

Clearly, the issue of whether implicit interest rates are usurious has profound implications for Muslims everywhere. My own informal reading of Islamic literature seems to suggest that *riba* is forbidden, *be it in money terms or in kind*.³ If Muslim jurists agree with that, then Muslims in the United States and elsewhere should not have *any* dealing with non-Islamic commercial banks, not even depositing their money in checking accounts that bear no interest rates. But then, is there any alternative available to Muslims who are compelled to using checks in settling their transactions? It seems that such dilemma further highlights the necessity of establishing Islamic banks that are governed by strict Islamic rules. In my view, an Islamic bank can avoid the problem of implicit interest rates on non-interest bearing deposits by *fully* charging for bank services whatever the bank incurs in producing these services.⁴

In the preceding discussion, I have attempted to focus attention on a much neglected aspect of non-Islamic commercial banks, namely the issue of implicit interest rates. Admittedly, this discussion has raised more questions than it has answered. But then this is precisely my main objective in this note.

²See Qureshi (1967), Mannan (1970) and Siddiqi (1983) and the references cited therein.

³A similar view may be gleaned from Kahf (1977).

⁴In addition, this arrangement would induce the public to hold the socially optimal quantity of money balances since they will take into account the correct opportunity cost of banks' resources utilized in producing payments services. For more on this, see Johnson (1968).

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