

Guaranteeing Investment Deposits in Islamic banking System

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ABSTRACT: For developing a viable Islamic banking system, protection of depositor's money is a basic and crucial question. A depositor wants both security and growth for his saving but Islamic banking provides him only one. This would have led the majority of household to shy away from the system which no country can afford. So there is genuine "need" – a *darurah* to provide such guarantee. It is also necessary to maintain social justice. Until this need is recognized by *shariah* experts, '*murabahah*' and concept of '*tabarru*' (voluntary donation) may be used by Islamic banks to guarantee the principal amount of depositors. In this regard al-Tegani's arguments make Shariah as well as economic sense. Such a practice will also be conducive to reducing the possibility of moral hazard on the part of the bank in the use of the depositors' money. To guarantee the deposit as an act of *tabarru*', banks may keep a fraction of the annual income of shareholders in a special account of shareholders which could be used to compensate the depositors for any loss of their principal amount that may occur when doing business with their money.

Guarantee of deposits is at the core of the contemporary "banking" business. If we are talking of "banking" and if we are talking in the context of open economy then protection of depositor's money will remain a basic and crucial question in developing a viable Islamic banking system. This issue may not be very important at the level of individual institution. The issue is, however, very important in the context of a country intending to change entire financial system to conform to Shari'ah.

"Banking" is a contemporary need of individuals/households of small means and small savings who want to see their savings grow but are scared of subjecting them to any risk bearing which may possibly result into a loss of all or part of their savings. An individual/household saver is faced with a dilemma. Savings are needed for future consumption. The real value of these savings gets depleted by inflation. He is not only worried to keep his savings safe and secure but he is also worried in finding ways to make savings grow to fight the effect of inflation.

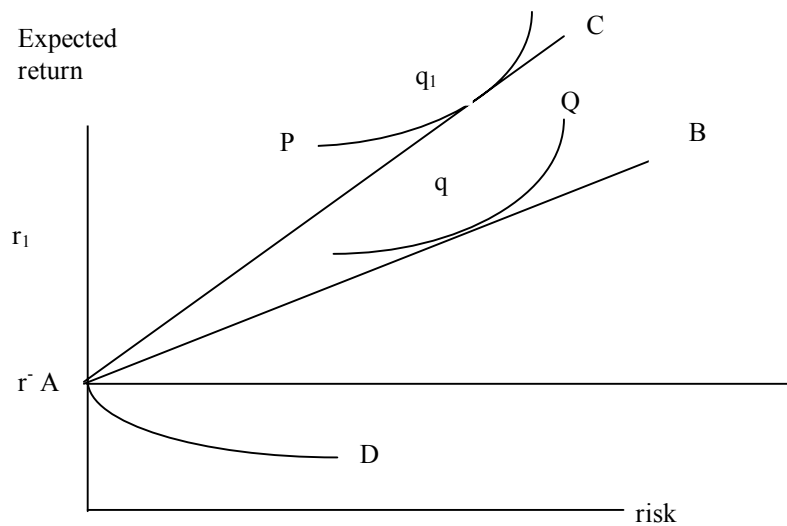
Islamic banking provides him only two choices:

- a) If he wants security, his savings will not grow (or may grow but not substantially).
- b) If he wants his savings to grow substantially, then he will have to take the risk of losing all or part of his savings.

If a financial system provides only these choices, the majority of households would shy away from the system and would look for other venues where their savings will be more secure and will not be substantially depleted in real value by the inflation. They may put their savings, for example, in gold or holdings of foreign currencies which are freely convertible and relatively more stable. No economy can afford to have a financial system where household savings will shy away from the system. We need to realize that banks are a need of individuals in a contemporary society and we need an Islamic banking system that attracts depositors and does not make them shy away.

There are several economic arguments to prove that under the contemporary economic and financial set up, the banks guaranteeing deposits (while paying return on them) is a genuine “need” – a *darurah* – of certain sections of society and a genuine need of economy as a whole under certain macro economic conditions.

For example, consider the following model from portfolio choice theory:



Suppose Islamic banking system in an economy is offering r as expected rate of return in a *murabahah* based mutual funds such that there is a negligible risk. The return fluctuates in very narrow range while the deposits remain guaranteed because of

the *murabahah* principle⁽¹⁾. This serves as a floor in the portfolio choice. The banks also offer a spectrum of portfolio which give higher return with higher risk. The complete choice set for the depositors in the banking system can be represented by the line AB.

In an economy we can easily distinguish two types of savers/depositors:

Type I Savers: Willing to take risk subject to their risk-return preferences and the risk-return packages offered by various investment opportunities in the economy including risk bearing investment deposits of the banks.

Type II Savers: Not willing to take any risk at all.

In this scenario, assume that the banks are not guaranteeing deposits except in *murabahah* based mutual fund which offer r^* rate of return with negligible risk. With the given risk-return preference of depositors shown by the curve PQ, the type I saver/depositor optimizes at point q and earns an expected return r_1 . Type II depositors only have one choice which is to deposit in a *murabahah* based mutual fund (which provides guarantee of principal amount) and earn r^* and hence be on a lower welfare level D. Though I cannot give statistics here, it may not be unknown to the reader that the banking sector of an economy receives more deposits from type II deposits than from type I deposits and it may also not be disputed that the type II deposits belong to lower income strata of the economy than the type I deposits. There is a serious social justice issue here. The banking system and hence the economy is benefiting more from the resources of poorer strata but it is the richer strata of the economy where welfare is improved more.

If it becomes permissible for the banks to guarantee all deposits including the risk bearing investment deposits other than *murabahah* based Mutual Funds, then the risk return relationship offered by the Islamic banks will become steeper (see line AC). Three things will happen:

- a) Type I depositors welfare will increase from q to q_1 .
- b) Bulk of the type II depositors will be willing to take decision (of investing in the risk bearing deposits of the bank)⁽²⁾ along the line AC, as now it implies taking risk with respect to income only and not with respect to their principal amount.

(1) All commercial banks in Saudi Arabia, for example, are offering such accounts; offering almost similar rate of return (around 5 percent) with guaranteed principal on mutual funds based on *murabahah* principle. So it is possible to have a benchmark of almost risk free return for bank deposits.

(2) The risk bearing now would be with respect to income which may widely fluctuate but no risk bearing with respect to principal amount of deposits.

- c) Bulk of the depositors with the banking system now will be at par with respect to earning return on their deposits and the social justice issue mentioned above will be minimized.

It is the last point that justifies the claim that guaranteeing of deposits by Islamic banks be considered a need and a *darurah* of Islamic economy to maintain social justice.

I will haste to add that I am giving this argument only for the depositors in the banking sector of an Islamic financial system⁽³⁾ and not for any investor or *rabb al-mal* in a *mudarabah* contract elsewhere in an Islamic economy as a whole. The following points need to be noted in this respect:

- 1) Depositor, as a *rabb al-mal* in a *mudarabah* account, in a bank does not have the same economic status and privileges as an investor (*rabb al-mal*) will have anywhere else in the economy over the *mudarib* (or as a bank will have over its clients while investing its funds with them in a *mudarabah* contract). The distinction lies in the fact that who can potentially exploit whom. If banks, as a *mudarib* get, on the strength of Shari'ah injunction, a potential capability to put their less privileged depositors at a disadvantage vis-a-vis affluent depositors then this needs to be corrected.
- 2) When a depositor deposits money in the bank, he only trusts the financial system and the legal framework of the society within which the bank is working. There are no other guarantees that the depositor can claim. This is not the case with other investors. They can seek guarantees, they can monitor the use of their money more closely, they can have their own lawyers and auditors to send warnings and invoke guarantees for any misuse of their money. There is, therefore, a need of some mechanism that can provide the depositors with similar protections that other investors enjoy in the economy. Guaranteeing their deposits will be one such mechanism.
- 3) It is unfair to ask an individual funds seeker to guarantee the funds of *rabb al-mal* and also pay a return on it because the individual funds seeker does not have the capacity to reduce all the risks faced by his business. This is not the case with the bank. They have the capacity to choose and diversify and use other means to minimize their risk, (at least minimize the risk of loss of capital). It will, therefore, not be unfair to ask banks to guarantee the principal amount of depositors.

(3) Some others have given similar argument to make a case against elimination of interest from the economy. Using the same framework as in the diagram, they argue that the elimination of interest from the economy will make lenders worse off. This argument may appeal shy-lock, but for elimination of interest at economy wide level, this argument is not valid. For more discussion on this, see **Khan** (1412 H/1991G).

The conclusion so far is:

- a) Guaranteeing deposits in an Islamic banking system is a need of individual and society, particularly on grounds of justice (*al-'adl*).
- b) Deposits in the banking system need to be guaranteed but not the return.
- c) The guarantee of principal amount is not needed for investors other than depositors in the banking system.

The absence of the guarantee of principal amount of deposits in a banking system will result into the following:

- 1) Certain vulnerable groups of society who cannot afford to take any sort of risk on their deposits will find themselves at disadvantage in the financial system compared to other groups which are not so vulnerable and can afford to take risk. In general the welfare of depositors of economically less privileged groups in the society will be reduced.
- 2) Banks' capacity to mobilize resources will decline substantially which will create simply a dead weight loss and the money not coming to the banking system may end up sitting in the form of unproductive assets.

I believe that economists and policy makers can make a strong case to Shari'ah scholars to allow Islamic banks to guarantee principal amounts of their depositors, as this is a genuine need of the economy as well as a means to maintain social justice. If Shari'ah scholars still cannot find a justification for a blanket permission to Islamic banks to guarantee all bank deposits in all circumstances, then Shari'ah scholars can at least specify conditions of *idtirar* (compulsion) in the context of *darurah* mentioned earlier, under which it may become permissible for banks to guarantee certain deposits under certain conditions. Economists can help Shari'ah scholars in specifying such conditions of *idtirar* at any particular point of time or for any particular class of depositors to ensure justice.

Until this need is recognized by Shari'ah experts, I believe some existing Shari'ah provision can be used by Islamic banks to guarantee, in the capacity of *mudarib*, the principal amount of their depositors. We conveniently found *murabahah* based financing as a permissible alternative close to interest based lending by simply utilizing Shari'ah permissibility of appointing bank's own clients (seeking funds) as its agent to purchase the goods needed by the client. I believe there is an equally, if not more, solid ground to utilize the Shari'ah acceptable concept of *tabarru'* (donation), as suggested by Al-Tegani⁽⁴⁾ for guaranteeing the principal amount of investment

(4) Al-Tegani, A. (1423H/2002G).

deposits. Tegani's arguments make Shari'ah as well as economic sense. The suggestion that *mudarib* can voluntarily agree to compensate for any loss of principal amount of *rabb al-mal* (in other words to guarantee the principal amount of capital in a *mudarabah* contract) deserves serious consideration particularly in the banks-depositors *mudarabah* relationship in an Islamic banking system. *Tabarru'* to pay more than principal amount in a loan contract is acceptable (though by definition, it would be *riba*), it apparently seems that a *tabarru'* on the part of the bank to compensate for a loss to the depositors will also be acceptable in Shari'ah particularly when

- a) in a contemporary banking system, where banks are heavily regulated and supported, the probability of a bank making a loss on the investment of depositor's money is small.
- b) banks are voluntarily willing to make the *tabarru'*.
- c) banks have the capacity to make such *tabarru'*.

Such a practice will also be conducive to reducing the possibility of moral hazard on the part of the bank in the use of the depositor's money. It will be superior alternative than asking banks to get the deposits insured or guaranteed by third party which in turn may lead to possibilities of moral hazards on the part of the banks.

Tabarru' may not make sense in case of investments other than bank deposits, obviously because of the possibility of *rabb al-mal* exploiting *mudarib*'s weak bargaining position. That is not the case in a bank-depositor relationship.

It, however, may be argued that if banks make *tabarru'* and end up guaranteeing all investment deposits then it would mean that *rabb al-mal* will be getting a profit without bearing any risk of loss. This will be violating the principle of *al-kharaj bi-al-daman* (الخارج بالضمان). While a bank may not feel any uneasiness in making a *tabarru'* to guarantee the deposits, some depositors may feel uneasy for receiving a profit without bearing the risk of loss. Such depositors may probably feel happy if banks make *tabarru'* to compensate not all the loss but only a part of the loss – for example compensating 90 percent of the loss. It may not be considered as merely a subterfuge, because most often no one will be benefiting from this, except that depositors will have more peace of mind while keeping their life time savings in a bank's investment account to make their savings grow. Only banks may some times end up losing part of their income that they were permitted to keep.

Now let us see what would it mean for the banks to make such a *tabarru'*. Banks, when they make such a *tabarru'*, may like to retain a fraction of the yearly income of shareholders in a special account of shareholders which would be used to compensate the depositors for any loss of their principal amount that may occur when doing business with their money. Maintaining such an account from contributions from shareholder's income will be similar to paying an insurance premium to a third party

to guarantee the depositors' principal amount. Maintaining own special account rather than paying a third party for deposits' insurance is a better option as it would reduce the possibility of moral hazard on the part of the banks' management in using depositor's money.

References

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ضمان الوديعة الاستثمارية في النظام المصرفي الإسلامي

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المعهد الإسلامي للبحوث والتدريب

البنك الإسلامي للتنمية - جدة

المستخلص : تعتبر حماية أموال المودعين من أهم دعائم بناء نظام مصرفي إسلامي متين . إن المودع يسعى إلى تحقيق الأمان والنمو لمدخراته ، غير أن المصرف الإسلامي لا يوفر له إلا أحدهما . هذه الحقيقة قد تؤدي إلى عزوف أصحاب المدخرات عن هذا النظام . لذا، فإن هناك ضرورة لتوفير نوع من الضمان إضافة إلى تحقيق العدالة الاجتماعية . ويانتظر أن يدرك ذلك المشرعون ، فإن المراوحة والتبرع يمكن أن يستخدم كوسائل ضمان للأموال المودعة ، الأمر الذي يعطي الحجج التي ساقها التيجاني نوعاً من المصداقية الشرعية والاقتصادية . كذلك فإن هذا الإجراء سيساعد في تخفيض مستوى المخاطر الأخلاقية من قبل البنك عند توظيفه لأموال المودعين . ومن أجل ضمان هذه الودائع من خلال التبرع يمكن للبنوك أن تحتفظ بجزء من الدخل السنوي العائد للمساهمين في حساب خاص يستخدم لتعويض المودعين عن أي خسارة لرؤوس أموالهم أثناء توظيفها .