



Financial Safety Nets

Striking a Balance between Sharī'ah Requirements and the Soundness of the Islamic Financial System



ISLAMIC FINANCIAL
SERVICES BOARD

ISRA

الأحاديث العالمية للبحوث الشرعية
International Sharī'ah Research Academy for Islamic Finance

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This IFSB-ISRA Joint Publication is printed with
Technical Assistance Support from the Asian Development Bank



Published in 2017 by

Islamic Financial Services Board
Level 5, Sasana Kijang, Bank Negara Malaysia
2, Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia

International Shari'ah Research Academy for Islamic Finance
Lorong Universiti A, 59100 Kuala Lumpur, Malaysia

Printed in Malaysia

ISBN 978-967-5687-61-7

Perpustakaan Negara Malaysia

Cataloguing-in-Publication Data

Financial Safety Nets: Striking a Balance between Shari'ah Requirements and the Soundness of the Islamic Financial System

ISBN 978-967-5687-61-7

1. Banks and banking--Religious aspects--Islam. 2. Lenders of last resort. 3. Finance--Religious aspects--Islam. 4. Financial services industry.

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Printed by:

Absolute.creative
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Design and Layout by:
Noor Aznir Nizam bin Noordin

ISBN 978-967-5687-61-7



9 789675 687617



ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The Islamic Financial Services Board (IFSB) is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets, and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involve, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars, and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional, and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit www.ifsb.org.

ABOUT THE INTERNATIONAL SHARI'AH RESEARCH ACADEMY FOR ISLAMIC FINANCE (ISRA)

The International Shari'ah Research Academy for Islamic Finance (ISRA) was established in 2008, by Bank Negara Malaysia (the Central Bank of Malaysia), as an initiative to promote applied research in the areas of Shari'ah and Islamic finance. ISRA also acts as a knowledge repository for matters related to Shari'ah and fatwas (resolutions) in the Islamic finance industry. ISRA also contributes towards strengthening human capital development and provides platform for greater engagement amongst regulators, scholars, academicians, industry players via research and dialogues both in local and global arena.

For more information about ISRA, please visit www.isra.my.

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FOREWORD

Financial safety nets today feature as a key component of an integrated financial stability framework, in which safety nets are closely linked to strong capabilities for crisis management and for the prudential regulation and supervision of the financial system.

The importance of this integrated framework was highlighted during the Global Financial Crisis (GFC), when liquidity in financial markets dried up, with adverse consequences for the operations of the financial system and for consumer confidence in the safety of their deposits.

Thus, a key result of the GFC has been the recognition that it is necessary to strengthen the lender-of-last-resort (LOLR) function for the provision of liquidity to banks and other financial institutions in order to stabilise financial markets, while also improving the design and efficiency of deposit insurance schemes.

As a key component of a sound and stable financial framework, the development of and issues surrounding financial safety nets is a subject closely linked to the mandate and operations of the Islamic Financial Services Board (IFSB) – which is to promote the stability and resilience of Islamic finance globally through the issuance of standards for the prudential regulation and supervision of the various sectors, and to support their implementation in member jurisdictions.

In 2010, a joint IFSB and Islamic Development Bank Task Force led by Governor Dr. Zeti Akhtar Aziz identified “strengthening financial safety nets” as one of the key building blocks for strengthening the resilience of Islamic financial systems in the post-crisis world. The Task Force, in its publication titled *Islamic Finance and Global Financial Stability*, pointed out that safety-net mechanisms particularly LOLR facilities and deposit insurance need to be compatible with Sharī‘ah principles. Similarly, another building block emphasised the development of “effective crisis management and resolution frameworks”, which includes bank insolvency and asset recovery laws, as well as restructuring and recapitalisation of the underlying financial institutions.

These components of the financial safety-net arrangements are key to sustaining financial stability especially when a system is confronted with a financial shock. The implementation of a well-designed Sharī‘ah-compliant deposit insurance scheme for Islamic financial services is particularly challenging given the intricacies of the funding structure of institutions offering Islamic financial services (IIFS).



Realising that the rapid growth of Islamic finance underscores the need for addressing the subject and its corresponding issues, the IFSB and the International Shari'ah Research Academy for Islamic Finance (ISRA) jointly organised a Shari'ah roundtable, "Financial Safety Nets: Striking a Balance between Shari'ah Requirements and the Soundness of the Islamic Financial System", held on 5 November 2015.

The roundtable aimed to provide a platform for Shari'ah scholars to lead the discussion by regulators, market players and legal practitioners of the key aspects of LOLR and deposit insurance schemes, in order to identify the major obstacles, issues and challenges in introducing such facilities in different jurisdictions. The roundtable focused on two working papers produced by the IFSB on the subject of financial safety nets.

The first session of the roundtable was on the issue of LOLR facilities, which is the theme of a working paper issued by the IFSB in 2014. The current practice of managing liquidity through an interbank *murābahah* or *wakālah* arrangement may function well under normal market conditions, but more efficient and tradable Shari'ah-compliant financial instruments are required for LOLR facilities and emergency financing operations when interbank liquidity comes under pressure, such as in a crisis situation. This calls for the development of an adequate range of tools and instruments for LOLR and emergency financing operations that are consistent with the core objectives and principles of Sharī'ah, both in form and in economic substance.

The second session addressed the issue of Sharī'ah-compliant structures for a deposit insurance scheme, which is the focus of an upcoming IFSB working paper titled "The Role and Mechanisms of Sharī'ah-Compliant Deposit Insurance Schemes (SCDIS)". This paper examines the Sharī'ah basis for supporting such a mechanism, highlights the current models of Sharī'ah-compliant deposit insurance schemes that are being implemented in different jurisdictions, and addresses the Sharī'ah, legal and operational challenges that need to be considered in the implementation of SCDIS.

The IFSB and ISRA would like to thank the distinguished scholars whose papers form the core of this publication. The papers, as well as the complementing chapters, underwent many reviews by Dr. Sa'id Adekunle Mikail of ISRA and Br. Madaa Munjid of the IFSB Secretariat during the writing and translation processes of the publication. They were supported by Dr. Mustafa Omar Mohammed and the teams at the IFSB Secretariat, headed by the Assistant Secretaries-General, Zahid ur Rehman Khokher and Dr. Sherif Ayoub, and at ISRA, led by the Head of Research Quality Assurance Office, Dr. Marjan Muhammad.



It is hoped that this publication, which encapsulates the combined knowledge of the distinguished scholars, industry practitioners and academics, will be a useful resource for better understanding of the Sharī'ah issues related to safety nets and a valuable reference for jurisdictions and organisations that aim to better understand and develop these important facilities in order to strengthen their respective financial frameworks.

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INTRODUCTION

The start of the 1930s marked the beginning of the Great Depression in the United States and elsewhere. The collapse of the Bretton Woods System in the early 1970s was followed by even bigger economic and financial crises. Since then, the continuous rise of financial globalisation has increased volatility in the global economic and financial system. The 1980s, 1990s and, recently, 2008–9, saw frequent banking and financial crises in diverse regions globally. The aftermath of these crises in the form of banking sector failures has led to increased interest by policymakers in studying the need for financial safety nets.

The conventional financial system has well-designed financial safety nets in place, particularly those related to crisis prevention strategies, as part of a comprehensive regulatory and supervisory framework designed to ensure the soundness and stability of the system.

Cognisant of the need for such financial soundness and stability in the Islamic financial industry, the Islamic Financial Services Board (IFSB) has been highlighting in its various publications and initiatives since 2005 the need for Shari'ah-compliant financial safety net facilities.

On 17 November 2011, the Islamic Financial Stability Forum (IFSF), a Council of the IFSB, held its fourth meeting with the theme, "Strengthening Financial Safety Nets: Shari'ah-Compliant Lender of Last Resort (SLOLR) Facilities and Emergency Financing Mechanisms as well as Deposit Insurance". The proceedings, among other initiatives, requested the Secretariat to conduct detailed cross-border studies on SLOLR facilities and a Shari'ah-compliant deposit insurance scheme (SCDIS). Accordingly, an industry-wide survey on SLOLR and SCDIS was carried out as a stock-taking exercise among 38 banking regulatory and supervisory authorities (RSAs), including central banks, and monetary authorities who are members of the IFSB, between 19 June and 31 July 2012. The preliminary draft of the survey results was presented to a series of IFSB Technical Committee (TC) meetings to solicit feedback. The 31st IFSB meeting, held on 24 October 2013, agreed, among other things, to publish the draft as two separate working papers of the IFSB, one on SLOLR and the other on SCDIS. The papers were presented in a Shari'ah roundtable, organised jointly by the IFSB and ISRA, on 5 November 2015 in Kuala Lumpur. Shari'ah-related papers corresponding to the two topics – SLOLR and SCDIS – were also presented. The roundtable was themed "Financial Safety Nets: Striking a Balance between Shari'ah Requirements and the Soundness of the Islamic Financial System". The event provided a forum for intellectual discourse between Shari'ah scholars and industry players on Shari'ah and practical issues related to these two topics. It was agreed that the papers presented at the roundtable and the ensuing



discourse would be jointly published by IFSB and ISRA in 2016. The rest of this introduction summarises the issues described and recommendations proposed in the six papers included in this joint publication.

Summary of Three Papers on SLOLR

Chapters 1 to 3 consist of one IFSB working paper and two Shari'ah papers on SLOLR. The IFSB working paper is divided into six sections, including the introduction. Section 1.2 sets out the conceptual understanding of the LOLR mechanisms. Section 1.3 focuses on the Shari'ah perspective on, and Shari'ah issues related to, LOLR. Survey results and discussion are presented in section 1.4. Section 1.5 discusses the potential structures for developing the SLOLR facility. Section 1.6 concludes the study and suggests a way forward.

Section 1.1 provides the background to and motives of the study. It raises seven pertinent research questions related to Shari'ah issues, mechanisms, current status, structures, challenges and how to develop SLOLR. **Section 1.2** discusses the conceptual understanding of lender-of-last-resort mechanisms based on the classical definition of LOLR, which continues to influence central bank policy today. According to this concept, the central bank, acting as LOLR, prevents temporarily illiquid but otherwise solvent banks from failing in times of panic, by freely advancing reserves to any private bank able to offer collateral. The lending is extended at a [high] penalty rate as the best remedy for the worst money market malady and to discourage unnecessary applications from banks. Critics of the doctrine argue that, in a situation of financial crisis, it is not easy to tell the difference between an illiquid and an insolvent institution; that lending has frequently taken place at prevailing market rates and not the penalty rate; that LOLR results in moral hazard; that open market operation (OMO) is the only policy required to stem a liquidity crisis; and that a central bank should allow insolvent banks to fail in order to discourage financial institutions from taking greater risks.

Section 1.3 of the paper examines the Shari'ah perspective on LOLR from two points of view. First, it considers the issue from the point of view of *maqāṣid al-Shari'ah*, which emphasises the protection of wealth from risk, harm and damage. Hence, Shari'ah would require the central bank to provide an LOLR facility to illiquid institutions offering Islamic financial services (IIFS) that are unable to find any other sources of funds to protect them from collapsing. The second perspective is that of Shari'ah-oriented public policy (*siyāsah shar'iyyah*), where state intervention in the market for the purpose of promoting public interest and preventing general harm is considered legitimate by the Shari'ah. In the case of an LOLR facility, it is necessary for the state to rescue troubled banks, as it is the state's role, as delegated to the



central bank, to maintain the stability of the overall financial and monetary system. This section has also raised Sharī'ah issues in LOLR related to *fiqh mu'āmalāt*. The discussion covers two spheres. The first sphere apparently does not raise particular Sharī'ah issues, and relates to the central bank payment and settlement system for an LOLR facility and the central bank informing of its readiness to freely provide funds in the case of a crisis. The second sphere comprises issues related to interest-bearing loans, collateral and the reference to a "penalty rate". The structure of SLOLR to be developed must be free of an interest-bearing element as practised in conventional LOLR. Meanwhile, illiquid IIFS can provide a Sharī'ah-compliant asset as collateral to obtain an SLOLR facility provided the asset has a good rating, is marketable and complies with the condition of *rahn*. The high penalty rate commonly stipulated in the conventional LOLR can be replaced with a high profit rate in the case of SLOLR. Such a profit rate, however, must fulfil the Sharī'ah condition of mutual willing consent (*tarāḍī*), be free from *ghubn fāḥish* (excessive inequality) and use a suitable underlying contract and benchmark rate.

In **section 1.4**, the survey results cover the following areas: general information; current status and supervisory assessment of the SLOLR facility; the practices, design and structure of the existing SLOLR facilities; key challenges of an SLOLR facility; and other issues that are vital in the development of an SLOLR facility.

In general terms, the results of the survey shows that 85% of the RSAs have acknowledged that an LOLR facility is commonly available to their banking institutions. Moreover, the majority of the RSAs use OMO and standing facilities as tools for monetary operation. With regard to their current status and supervisory assessment, the RSAs are at different stages of development of an SLOLR facility. Thirty-eight per cent of RSAs (9 out of 24) revealed that SLOLR facilities have not been developed in their respective jurisdictions, as they have conventional LOLR facilities to cater for IIFS' needs. Some of the assessments show that one-third of the RSAs have adapted the relevant legal, tax and regulatory aspects to accommodate the development of an SLOLR. On the other hand, the results indicate that the practices, design and structure of the existing SLOLR facilities are inadequate. Only six of the 24 RSAs surveyed have a mechanism in place to provide SLOLR facilities exclusively to fully fledged Islamic commercial banks. These six RSAs use underlying Sharī'ah-compliant structures such as *muḍārabah*, *mushārah*, *murābaḥah*, *tawarruq*, *qarḍ* with *rahn*, commodity *murābaḥah* and short-term *ijārah ṣukūk*.

What are the significance and key challenges of the SLOLR facility? Nearly all the RSAs in the sample agree that the seven aspects presented to them were significant for developing an SLOLR facility. The RSAs were also asked to rank seven key challenges they could have encountered in developing an SLOLR facility. The most



significant challenge is the adaptations and/or modifications to the existing laws and regulations. The second-ranked challenge is the shortage of eligible Shari'ah-compliant good collateral and high-quality Shari'ah-compliant liquid assets. Apart from these seven challenges, the RSAs were also asked about five other key issues that are not covered by the survey but are important in the development of an SLOLR facility. These issues include RSAs transacting directly in the markets, the existence of deposit insurance protection and an Islamic money market, and the role of the International Islamic Liquidity Management Corporation (IILM).

As for **section 1.5** it dealt with potential Shari'ah compliant structures that could be used for the development of SLOLR facilities, such as *qard ḥasan*, commodity *murābaḥah*, *muḍārabah*, *takāful* and *mushārah*. The uses of structures may vary from simple to complex, depending on the particular RSA.

In addition to the IFSB working paper, two other Shari'ah papers on SLOLR are also included in this IFSB–ISRA joint publication. The first of these papers comprises the following eight sections: (1) issues under study; (2) the significance of the study; (3) the importance of the LOLR in the realm of banking; (4) mechanisms for performing the LOLR function; (5) why it is called LOLR; (6) the issues of conventional LOLRs from the Shari'ah perspective; (7) alternatives to the loan-based LOLR in the Islamic banking literature; and (8) the proposed mechanisms of LOLR.

Section 2.1 identifies the issues arising from the inactive relationship between the central bank and Islamic banks and from the central bank's failure to adopt instruments that take into consideration the unique features of Islamic banking. **Section 2.2** discusses the importance of LOLR for financial stability. **Section 2.3** discusses the importance of the LOLR in banking activities. It relates how the fractional reserve system allows banks to create credit in the system. If clients want to withdraw all their deposits at the same time, the banks will not be in a position to fulfil their obligations. This demonstrates the vulnerability of the banking sector. Banks try to manage their liquidity positions in normal times through the interbank money market, among other means. But in the case of shocks, the situation can become contagious if left unattended. Hence, the LOLR plays a vital role. **Section 2.4** outlines ways of performing the task of LOLR, which include direct lending, repurchase agreements and debt securities. **Section 2.5** answers the question, "Why is it called the LOLR?" It shows how the function of the central bank becomes critical in a situation where there is a liquidity problem. The section also presents a view that the LOLR can become a source of moral hazard. In **section 2.6**, the issues of conventional LOLR from the Shari'ah perspective are analysed. These issues include interest-based loans; repurchase contracts; and the failure of central banks to adopt genuine Islamic alternatives. **Section 2.7** discusses alternatives to the loan-based LOLR available in the Islamic banking literature. The analyses



focus on the merits and demerits of the *muḍārabah* contract between the central bank and the Islamic bank, and the LOLR's use of mutual loans and of commodity *murābaḥah*. The *muḍārabah* facility is considered problematic because the capital cannot be guaranteed, which is a requirement for the central bank LOLR facility. The mutual loan facility is contentious because it is tantamount to *ribā*. Meanwhile, the depth of the commodity market limits the commodity *murābaḥah*, and its procedure is complex for large amounts. In the final section, **section 2.8**, two structures for SLOLR, *muḍārabah* and repurchase agreements, are proposed. In *muḍārabah*, a profit-sharing scheme between the central bank and an Islamic bank on a daily basis is suggested. If the *muḍārabah* contract exceeds one day, it becomes debt on the second day.

The second Shari'ah paper consists of four sections: (1) introduction; (2) the fundamentals of LOLR; (3) alternatives to the conventional LOLR; and (4) conclusion. **Section 3.1** provides the rationale for SLOLR and spells out the primary objective of the paper. **Section 3.2** consists of four subsections – namely, the concept of LOLR, its significance, the procedures for fulfilling liquidity needs, and the conventional LOLR instruments. These four subsections mainly discuss the standard role of the central bank in LOLR, its relationship with the banks in need of liquidity, the rationale for LOLR (such as financial stability), the procedures for fulfilling liquidity needs through interbank sale of assets and through LOLR, and LOLR instruments and the duration of their maturity. **Section 3.3** discusses four alternatives to the conventional LOLR. These alternatives are: (1) the repurchase agreement; (2) *muḍārabah* financing; (3) *qarḍ ḥasan*; (4) establishment of a joint liquidity fund. Most of the discussion of these four instruments follows the standard discussion in the literature, focusing on the Shari'ah conditions for their validity. For example, in the repurchase agreement, the sale must be genuine, and the price in the second contract must follow the market or the predetermined price.

Summary of Three Papers on SCDIS

Similar to the treatment of Shari'ah-compliant lender of last resort facilities in the first part of this publication, the latter part consists of three papers (Chapters 4–6) – an IFSB working paper and two Shari'ah papers – on Shari'ah-compliant deposit insurance schemes. The IFSB working paper (Chapter 4) is structured into five sections, including the introduction. Section 4.2 reviews the literature on the conceptual framework of deposit insurance schemes (DIS). Section 4.3 justifies the need for developing SCDIS. Section 4.4 discusses the results of the IFSB survey in relation to the existing DIS and the current modalities and features of SCDIS in practice. Section 4.5 concludes the paper.



The introductory section provides the background of the paper and the rationale for SCDIS. In **section 4.2**, the paper reviews the literature on the significance of DIS and its effectiveness. DIS is considered an essential component of financial safety nets, established to promote financial stability and protect small savers from losses in the case of a troubled or failing bank. The concept of national DIS originated from Czechoslovakia, which in 1924 was the first country to establish a nationwide deposit scheme. With increased demands, the number of countries offering DIS increased from 49 in 1995 to 113 in 2014. Despite the widespread acceptance of DIS, economists hold two opposing views about its effectiveness. The first view asserts that DIS as policy tools can reduce the likelihood of bank runs. In contrast, the second view argues that DIS induces moral hazard incentives that encourage banks to increase the risk of default due to their limited liabilities or the assurance that depositors' funds are guaranteed.

Section 4.3 rationalises the potential for establishing SCDIS, following the finding of the IFSB's 2015 IFSI Financial Stability Report that at least 10 jurisdictions and 31 Islamic banks have achieved domestic systemic importance that warrants a consideration of establishing SCDIS. The finding is supported by the IMF Staff Discussion Note that very few countries with Islamic banks have a full-fledged SCDIS. The IFSB has noted in its various standards that a jurisdiction establishing SCDIS must ensure that its aims and operations are consistent with the objectives of the Shari'ah. Thus, in a bid to facilitate the means to develop SCDIS and enhance the existing DIS, the IFSB Secretariat conducted a survey of member RSAs between July and August 2014.

Section 4.4 presents the results of this survey in five sections – namely, current DIS for IIFS, modalities of SCDIS, governance structure and design features, key challenges in operationalisation, and key considerations in SCDIS.

With regard to the current DIS for IIFS, the results show that 67% of the RSAs (18 out of 27) have in their respective jurisdictions a conventional DIS facility that is granted to both conventional and Islamic commercial banks. Meanwhile, only four RSAs out of 24 – Bahrain, Malaysia, Nigeria and Sudan – have developed and implemented special SCDIS facilities for IIFS. Selected SCDIS modality structures in five jurisdictions – namely, Bahrain, Malaysia, Nigeria, Sudan and Jordan – are presented. These modalities vary in terms of the year of establishment, rationale for establishment, categories of IIFS covered, types of accounts protected, the entity covered, underlying contracts, contributors, nature of the scheme and coverage limit. For example, almost all types of accounts are protected except for restricted and unrestricted investment accounts in Malaysia, and restricted investment accounts in Bahrain and Jordan.



The findings on the governance structure and design features cover governing body structure, Sharī'ah compliance arrangements, nature of the SCDIS scheme and investment strategy, accumulated contributions at SCDIS, contributions and risk assessment at SDIS, trigger for payments and responsibility of trigger activation, timetable and priorities for payments to eligible clients, and the use of SCDIS in the past and its testing in simulation. For example, with respect to payments to eligible clients, Sudan and Nigeria have timetables that also prioritise payments. The RSAs in Sudan had used SCDIS in the past (in response to an actual banking failure), while only Malaysia had tested SCDIS in a simulation of a banking failure.

In terms of the key challenges in operationalisation, 20 RSAs that do not have SCDIS ranked, from a list of six challenges, legal issues (such as formulating the necessary changes to existing laws, regulations etc.), Sharī'ah issues (such as differing interpretations of Sharī'ah rulings, or *fatāwa*, on financial matters across the jurisdiction), and legislative issues (such as securing the necessary approvals from the legislative body, Ministers, etc.) as the most significant challenges. In addition to these, other challenges identified by some RSAs include: differing Sharī'ah views on "deposit" insurance, development of a risk premium assessment methodology, public awareness of SCDIS, and a shortage of high-quality (highly rated) Sharī'ah-compliant liquid assets. Meanwhile, findings on key considerations in SCDIS are covered in two areas. First, Sharī'ah considerations include: Who owns *takāful* funds? To what extent can investment account holders (IAHs) be protected by SCDIS? And how are recoveries/subrogation in *takāful*-based SCDIS triggered? The second area of consideration is compliance of SCDIS with international sets of principles. This would require the adoption of revised Core Principles for Effective Deposit Insurance Systems released by the International Association of Deposit Insurers (IADI).

In addition to the IFSB working paper, two other Sharī'ah papers on SCDIS are included in the publication. The first Sharī'ah paper consists of five sections with several subsections. The introductory section focuses on the need to strike a balance between Sharī'ah requirements and the integrity of the Islamic financial system. It states that Sharī'ah demands a balance in economic activities, such as between private and public ownership. **Section 5.2** discusses the Sharī'ah-compliant structures of the banking deposit insurance scheme based on the resolutions of the OIC Fiqh Academy. Emphasis is laid on the prohibition of commercial insurance, the permissibility of cooperative *takāful*, its structures and how it is binding upon Muslim countries to adopt.

Section 5.3 discusses the issue of insuring current accounts and the permissibility of using cooperative *takāful* based on *al-nahd* and the commitment to donate or *al-hibah bi al-thawāb* (granting a gift with return). **Section 5.4** discusses the issue of



insuring saving and investment deposits deliberating on the attainable alternatives that could be used to mitigate risks. These include third party guarantee, the use of investment *wakālah*, feasibility studies and hedging against price fluctuation. **Section 5.5** discusses the insurance mechanisms that can be used to insure the three types of banking deposits. The section suggests some mechanisms of deposit insurance, such as Islamic banks collectively could negotiate the best offer from *takāful* companies, or these banks could establish a joint fund to bear losses if losses occur based on certain parameters.

Chapter 6 is structured in five sections: (1) introduction; (2) the nature of bank deposits; (3) procedural arrangements for an insurance system for investment deposits in banks; (4) models of deposit risk guarantee systems; and (5) conclusion.

The introductory section provides background on the significance of deposit insurance and its historical account. The section also deliberates on the first SCDIS in Sudan in 1996, Turkey in 2001, and Malaysia and Indonesia in 2005. **Section 6.2** focuses on discussing the nature of investment accounts, particularly the one based on a *muḍārabah* structure. **Section 6.3** on the other hand argues how this type of account can be guaranteed through partial and comprehensive arrangements. The partial arrangements consist of voluntary guarantees, reserves against losses, diversification of investment assets, sureties and options. While comprehensive arrangements include Islamic cooperative insurance (*takāful*) and risk guarantee institutions and funds. **Section 6.4** presents the modalities of SCDIS in four jurisdictions – namely, Sudan, Bahrain, Jordan, and Malaysia. The discussion focuses on the establishment of these modalities, the types of accounts involved, the fund contributors, triggers for payments to clients, and the strategy for investments. In Sudan, for example, the banks, the central bank and the government contribute to the scheme; while in Malaysia it is mandatory for banks to contribute to the scheme. **Section 6.5** concludes the study, summarising the findings related to the preceding four sections.



THE ROLE OF SHARĪ'AH-COMPLIANT LENDER-OF-LAST-RESORT FACILITIES AS AN EMERGENCY FINANCING MECHANISM: A SUMMARY OF RELEVANT DISCUSSIONS FROM THE IFSB WORKING PAPER (WP-01)*

* The IFSB Working Paper No. 1 was issued in April 2014, and prepared by Jamshaid Anwar Chattha and Wan Norhaziki Wan Abdul Halim, in consultation with Professor Simon Archer.



1.1. Introduction

Financial safety nets are very significant to regulatory and supervisory authorities (RSAs). They are part of a crisis prevention toolkit that is an integral part of a comprehensive regulatory and supervisory framework to ensure the soundness and stability of the financial system.

The concept and operational mechanisms of lender-of-last-resort (LOLR) have been widely addressed in the conventional literature. This concept has also provided a useful basis for institutions offering Islamic financial services (IIFS) to offer a Shari'ah-compliant LOLR.

Specifically, one prevention strategy is emergency liquidity assistance (ELA),¹ an instrument central banks use, at their discretion and as LOLR, to assist temporarily "illiquid but solvent" financial institutions in "exceptional circumstances". Such provision of liquidity is usually granted against adequate collateral.

Hence, in a situation of financial crisis where liquidity in the financial markets has often dried up, it becomes imperative to have an effective mechanism for providing Shari'ah-compliant lender-of-last-resort (SLOLR) facilities to support both IIFS and the Islamic financial services industry (IFSI). This raises a few pertinent questions: (i) What are the Shari'ah perspectives and potential issues related to LOLR facilities? (ii) What SLOLR mechanisms (if any) are already available for IIFS? (iii) What is the current assessment of the development of SLOLR facilities as a safety net? (iv) How are the existing SLOLR mechanisms structured by RSAs? (v) Have the monetary tools used by RSAs been adapted to cater to the specificities of IIFS? (vi) What are the key challenges and issues that need to be addressed before developing SLOLR facilities as a safety net? and (vii) How can an SLOLR facility be developed by RSAs? Finding answers to these questions is imperative, as the growing market share of IIFS in many jurisdictions, and their potential significance for ensuring systemic soundness and stability of the overall financial system, points to the need for SLOLR facilities. It is critical that the proposed SLOLR should have an integrated initiative for both Islamic and conventional finance for an effective crisis management framework at the jurisdiction level.

The Islamic Financial Services Board (IFSB) has been highlighting the need for developing SLOLR facilities in its various publications and initiatives since 2005. Accordingly, the Council of the IFSB established in its 15th meeting, held on 23 November 2009, the Islamic Financial Stability Forum (IFSF) as a high-level platform for the Council, RSAs and international organisations from among the IFSB members

1 The terms "ELA" and "LOLR" are used interchangeably in this study.



to discuss issues relating to the financial stability of the IFSI. In the 4th IFSF, held on 17 November 2011, the participants deliberated on the theme “Strengthening Financial Safety Nets: Sharīah-Compliant Lender-of-Last-Resort Facilities and Emergency Financing Mechanisms as well as Deposit Insurance”. Apart from the other deliberations, the proceedings of this Stability Forum highlighted the need to study SLOLR facilities in detail. In line with the proceedings, the Council in its 20th meeting, held on 29 March 2012, approved, among other things, the IFSB Strategic Performance Plan 2012–2015, which required the Secretariat to conduct cross-border studies, including a study on SLOLR facilities. The study was conducted and the findings were eventually published as the SLOLR working paper (IFSB WP-01). At the initial stage of developing the working paper, an industry-wide survey was carried out as a stock-taking exercise among 38 banking RSAs, including central banks, and monetary authorities that are IFSB members. The following is a summary of the important discussions included in WP-01.

1.2. Conceptual Understanding of LOLR Mechanisms

In the classical doctrine, Freixas et al. define the role of the lender-of-last-resort as:

«The discretionary provision of liquidity to a financial institution (or the market as a whole) by the central bank in reaction to an adverse shock that causes an abnormal increase in the demand for liquidity which cannot be met by an alternative source.»²

The “classical theory of the LOLR” continues to influence central bank policy today. The central bank, acting as LOLR, should prevent temporarily illiquid but solvent banks from failing. In times of panic, it should freely advance reserves to any private bank able to offer collateral. The lending is extended at a (high) penalty rate as the best remedy for the worst money market malady and to discourage unnecessary applications from banks. This policy of using reserves to stem panics should be clearly communicated well in advance of crises so that the market knows exactly what to expect, thus removing uncertainty.

There have been several criticisms made of the classical doctrine. For example, Acharya and Backus argue that in a situation of financial crisis it is not easy to tell the difference between an illiquid and an insolvent institution.³ In another study,

2 Freixas, X., B.M. Parigi and J.C. Rochet (1998). The Lender-of-Last-Resort: A Theoretical Foundation, (University of Toulouse: Mimeo).

3 Acharya, V.V. and D. Backus (2009). Private Lessons for Public Banking: The Case for Conditionality in LOLR Facilities, Chapter 14 (New York University Salomon Center and Wiley Periodicals, Inc.: New York).



the counterview is that a penalty rate has traditionally been judged relative to the prevailing market rate, and thus in practice, LOLR lending has frequently taken place at prevailing market rates.⁴ In terms of moral hazard, Goodhart argues that generous provision of liquidity by central banks, in normal times and in times of crisis, has made banks careless in managing their liquidity risks.⁵ Goodfriend and King opined that an open market operation (OMO) is the only policy required to stem a liquidity crisis. They argued strongly for the LOLR to function solely on the basis of OMOs to augment the stock of high-powered money.⁶ Meanwhile, Meltzer was of the opinion that a central bank should allow insolvent banks to fail, otherwise financial institutions will be encouraged to take greater risks.⁷

Despite these criticisms, the classical theory of LOLR continues to be prevalent. Recently, Cecchetti and Disyatat refined the theory and identified three types of liquidity shortages that can occur in the modern financial system: (i) a shortage of central bank liquidity; (ii) an acute shortage of funding liquidity at a specific institution; and (iii) a systemic shortage of funding and market liquidity.⁸

The simple operational structure of an LOLR facility involves four steps: (a) an illiquid and solvent bank requests the LOLR facility from the central bank (CB), which (b) lends (injects liquidity) to the illiquid bank via a discount window; (c) the bank provides eligible good collateral to the CB; and (d) it repays the principal loan plus penalty interest, and accordingly the collateral is released by the CB.

It can be deduced from the discussion above that the concept of LOLR is multifaceted and its practices vary across jurisdictions. This raises the issues of eligibility criteria and collateral, which are also very pertinent to defining the extent to which IIFS are in need of an LOLR facility.

Under normal circumstance, if an IIFS has a temporary liquidity problem, it has few options. It can seek interbank assistance from peer IIFS or Sharī'ah-compliant liquidity arrangements from conventional bank(s), or it can liquidate some of

4 Freixas, X., B.M. Parigi and J.C. Rochet (1998). *The Lender-of-Last-Resort: A Theoretical Foundation*, (University of Toulouse: Mimeo).

5 Goodhart, C.A.E. (2007). "Liquidity Risk Management", *Financial Markets Group Research Centre*, Special Paper No. 175 (October).

6 Goodfriend, M. and R.G. King (1988). "Financial Deregulation, Monetary Policy, and Central Banking", *Federal Reserve Bank of Richmond Economic Review* (May/June), pp. 3–22.

7 Meltzer, A. (1986). "Financial Failures and Financial Policies", in G.G. Kaufman and R.C. Kormendi (eds), *Deregulating Financial Service: Public Policy in Flux*, (Ballinger Publishing Company: Cambridge, MA).

8 Cecchetti, S.G. and P. Disyatat (2010). "Central Bank Tools and Liquidity Shortages", *FRBNY Economic Policy Review* (August).



its liquid assets to get the required funding or ask its parent company, if it is a subsidiary, to inject the required liquidity.

However, in a situation of financial stress in the market, all these options become difficult. Hence, the IIFS is likely to get the required funding through LOLR in the following scenarios where the central bank provides: (i) an intraday liquidity facility, (ii) liquidity to the market through OMOs; and (iii) liquidity to a specific IIFS that is on the verge of insolvency. This paper deals mainly with the first two scenarios.

1.3. Sharī'ah Perspective on, and Sharī'ah Issues in, LOLR

Sharī'ah Perspective on LOLR

This paper examines the Sharī'ah perspective on LOLR from two points of view – namely, *maqāṣid al-Sharī'ah* (the objectives of Sharī'ah) and *al-siyasah al-shar'iyyah* (Sharī'ah-oriented public policy).

An IIFS must ensure that its objectives and operations conform to *maqāṣid al-Sharī'ah* in terms of its forms, legal procedures and economic substance. All Muslim scholars have unanimously agreed that the ultimate objective of *maqāṣid al-Sharī'ah* is to promote the interests (*jalb al-maṣāliḥ*) of all mankind and to protect them from harm (*dar' al-mafāsid*). Al-Ghazālī categorised interests or *maṣlaḥah* (plural, *maṣāliḥ*) into three – namely, the exigency (*ḍarūriyyah*), the necessity (*ḥājiyyah*) and the embellishment (*taḥsīniyyah*). *Ḍarūriyyah* refers to benefits of life upon which people essentially depend; they comprise preservation of the five essential elements: faith, life, intellect, progeny and property. If these elements are ignored, then consistency and order cannot be established. *Ḥājiyyah* (or necessity) refers to benefits that complement the essential elements, the neglect of which will lead to hardship but not to total disorder of the normal life. *Taḥsīniyyah* refers to benefits whose realisation leads to enhancement and accomplishment in the customs and conduct of people at all levels of attainment.⁹

From al-Ghazālī's classification, protection of wealth from harm can be observed from two perspectives: (i) protecting wealth from risk that can harm it; and (ii) preventing wealth from being damaged through its use for harmful purposes. In addition to *al-maqāṣid*, there are two core Islamic legal maxims (*qawā'id fiqhiyyah*) that address the principle of harm prevention: (i) the removal of hardship (*raf' al-ḥaraj*); and (ii) prevention of harm (*daf' al-ḍarar*).

9 Al-Ghazālī, A. H. (1973). *Al-Mustaṣfā Min 'Ilm al-Uṣūl*, (Al-Maktabah al-Tijāriyyah: Cairo). pp. 139-140.



Therefore, the Sharī'ah strictly forbids exposing wealth to the danger of destruction. Such a situation could also occur in financial matters – for instance, in the case of risk management. If a major risk is not appropriately mitigated, it may lead to disastrous harm that may paralyse the economy and adversely affect the lives of the general public.

This scenario is also applicable in the case of illiquid IIFS that are unable to find any other sources of funds other than an LOLR facility from the central bank. Since the outright objective of providing such a facility to those IIFS is to protect the troubled banks from collapsing, it is thus viewed that such an act is in line with *maqāṣid al-Sharī'ah*. The denial of such an ELA provision to the troubled IIFS would not only lead to the collapse of the banks concerned, but might also cause catastrophic damage to a nation's economy.

In the case of LOLR, where an illiquid IIFS has no option other than obtaining an LOLR facility from the central bank, this situation can be classified as follows:

- (a) jurisdictions where the SLOLR facility is currently unavailable, and there is only the conventional interest-bearing LOLR;
- (b) jurisdictions where an SLOLR facility is available, but it is structured using certain Sharī'ah-compliant underlying contracts in such a way that there is disagreement regarding permissibility among Muslim jurists, such as an organised *tawarruq* (*tawarruq munazzam*) and/or a *bay' al-ṭinah* (sell and buy-back contract); and
- (c) jurisdictions where the SLOLR facility is available, and is structured using Sharī'ah-compliant underlying contracts in a way that is commonly accepted by Muslim jurists, based on the degree of the liquidity crisis affecting the illiquid IIFS.

The above three categories are assessed differently from the Sharī'ah point of view. In the first category, market intervention by the central bank for the purpose of maintaining continuous financial and monetary stability is recognised by the Sharī'ah because it is in line with the objective of harm prevention (*ḍaf' al-ḍarar*) in the *maqāṣid al-Sharī'ah*. In the case of the second category, the illiquid IIFS should also be permitted by the Sharī'ah to obtain such a "controversial" facility from the central bank, since there is no alternative to using such a facility. This case also follows the same Sharī'ah ruling pertaining to exigency as the former, in the sense that the harm arising from the collapse of the IIFS due to its liquidity crisis is more severe and disastrous to the nation's financial system than the harm represented by the use of the LOLR facility. The third category in a way is commonly accepted by Muslim jurists and hardly appears to be problematic from the Sharī'ah perspective, as the IIFS can subscribe to the SLOLR facility.



While examining the issues from the *al-siyāsah al-shar‘iyyah* point of view, it could be observed that, in Islam, matters relating to the state’s policy and direction aiming at securing and preserving the public interest, but not clearly stated in the Qur’ān and Sunnah, are indeed recognised by the Sharī‘ah based on Sharī‘ah-oriented public policy (*siyāsah shar‘iyyah*). The Sharī‘ah considers state intervention in the market for the purpose of promoting public interest and preventing general harm legitimate. In the case of an LOLR facility, it is necessary for the state to rescue troubled banks, as it is the state’s role, as delegated to the central bank, to maintain the stability of the overall financial and monetary system. Hence, the Sharī‘ah considers the execution of any policy by the central bank for the sake of maintaining monetary stability, fostering economic growth with full employment, and distributing economic justice legitimate.

Sharī‘ah Issues in LOLR

The Sharī‘ah issues in LOLR covered in this paper are related to *fiqh mu‘āmalat*. The discussion covers two dimensions. The first component apparently does not raise particular Sharī‘ah issues, such as central bank payment and settlement system for an LOLR facility and the central bank informing of its readiness to freely provide funds in case of crisis. The second element, which needs further deliberation, comprises issues related to interest-bearing loans, collateral and the reference to a “penalty rate”.

An interest-bearing loan is tantamount to *ribā*. The Sharī‘ah prohibits a loan extended for an extra repayment to be settled in the future. Thus, the conventional LOLR facility in which the loan is based on interest is forbidden from a Sharī‘ah perspective. Accordingly, the structure of SLOLR to be developed must be free from an interest-bearing element as practised in conventional LOLR.

Collateral, or *rahn*, is a security to a lender. It is permitted in the Sharī‘ah as evidenced by Quranic verses and several *aḥādīth*. In the contemporary application, any object that can be sold can be pledged or mortgaged as *rahn*. In the event of default, the asset pledged is liquidated to settle the outstanding amount of debt. Thus, an illiquid IIFS can provide Sharī‘ah-compliant assets as collateral to obtain an SLOLR facility. The asset must have a good rating, be marketable and comply with the condition of *rahn*.

The high penalty rate commonly stipulated in the conventional LOLR can be replaced with a high profit rate in the case of an SLOLR. Such a profit rate, however, must fulfil the Sharī‘ah conditions of mutual willing consent (*tarāḍī*), be free from *ghubn fāḥish* (excessive inequality) and use a suitable underlying contract and benchmark rate.



1.4. Survey Results and Discussion

The survey results cover the following areas: (i) general information; (ii) current status and supervisory assessment of the SLOLR facility; (iii) the practices, design and structures of the existing SLOLR facilities; (iv) significance and key challenges of an SLOLR facility; and (v) other issues that are vital in the development of an SLOLR facility.

General Information

Most of the RSAs reported that the market share of IIFS in terms of segments (banking, *takāful* and capital market) under their jurisdictions is less than 5%. Furthermore, 85% of the RSAs have acknowledged that the LOLR facility is commonly available to their banking institutions. In contrast, 15% say the facility is not available in their jurisdictions due to, among other things, the law not specifically stipulating the central bank as the LOLR and the law making no provision for an LOLR facility. Moreover, the majority of the RSAs use OMO and standing facilities as tools for monetary operation. Under OMO, 80% of the RSAs buy and sell money market instruments outright in the secondary market, and 84% resort to buying and selling assets under repo and reverse repo in a secondary market. Like OMOs, the majority of the RSAs have standing facilities such as a discount window (88%) and central bank deposit facilities (79%). From the Shari'ah perspective, the OMOs can be used as long as the government securities traded in the transactions are Shari'ah-compliant. However, the discount rate needs to be replaced by alternative mechanisms for the facilities to be compliant with Islamic principles.

Current Status and Supervisory Assessment of the SLOLR Facility

The RSAs are at different stages of development in terms of SLOLR facility. Thirty-eight per cent of the RSAs (9 out of 24) revealed that SLOLR facilities have not been developed in their respective jurisdictions as they have conventional LOLR facilities to cater for IIFS' needs. On the other hand, 37% of the RSAs that hitherto have not been required to offer an SLOLR place high importance on developing the facilities, due to the increasing market share of IIFS in the banking system. Meanwhile, in 25% of cases, SLOLR facilities have been developed in their jurisdictions.

Some of the assessments show that one-third of the RSAs have adapted the relevant legal, tax and regulatory aspects to accommodate the development of SLOLR. They also show that there is a continuing need to set out clear procedures and processes under which the central bank would act as SLOLR, and that there still exist Shari'ah constraints on the SLOLR facility.



Practices, Design and Structures of the Existing SLOLR Facilities

The results show that only six out of the 24 RSAs surveyed have a mechanism in place to provide SLOLR facilities exclusively to fully fledged Islamic commercial banks. However, in economic substance, these facilities are not much different from the ones provided by the conventional LOLR. The six RSAs, in their mechanism, use underlying Sharī'ah-compliant structures such as *muḍārabah*, *mushārah*, *murābahah*, *tawarruq*, *qard* with *rahn*, commodity *murābahah* and short-term *ijārah shukūk*. In addition to the latter two, Islamic Treasury bills or the equivalent, Islamic government investment certificates and Islamic certificates of deposit are perceived as highly useful and suitable for developing SLOLR support for IIFS. Nevertheless, finding suitable structures and instruments remains an ongoing challenge and is subject to further research.

Significance and Key Challenges of the SLOLR Facility

The respondents were asked to show their agreements and rank seven aspects that are considered significant for the development of an SLOLR facility. The majority of RSAs (78%) strongly agreed that central banks/monetary authorities should stand ready to assist all banks (including IIFS) faced with liquidity shocks in financial distress situations. Second, 65% of the RSAs strongly agreed with the need to have a clearer understanding of the Sharī'ah governance structures and efforts to facilitate the development of SLOLR facilities.

The RSAs were also asked to rank seven key challenges they could have encountered in developing an SLOLR facility. The challenge that was ranked as most significant was the adaptation and/or modification of existing laws and regulations. Ranked second was the shortage of a range of eligible Sharī'ah-compliant good collaterals and high-quality Sharī'ah-compliant liquid assets.

Apart from the seven challenges, the RSAs were asked about five other key issues that are not covered by the survey but are important in the development of an SLOLR facility. These issues include: (i) RSAs transacting directly in the markets; (ii) the existence of deposit insurance protection and an Islamic money market; and (iii) the role of international organisations such as the International Islamic Liquidity Management Corporation (IILM). Eleven out of 20 RSAs agreed that the central bank/monetary authority should transact directly in the markets where the problems originate, hence addressing them "at source", instead of providing SLOLR to certain IIFS during a crisis situation. In another key issue, 50% (10 out of 20) of the RSAs agreed that extending the existing safety nets to include Sharī'ah-compliant deposit insurance and developing the Islamic money markets (formal or informal) would reduce the need to develop SLOLR facilities in their jurisdictions.



Further, a significant majority (86% – 19 out of 22) of the RSAs agreed that the availability of well-designed regular liquidity facilities by the central bank would provide confidence to solvent and temporarily illiquid market participants.

1.5. Potential Structures for Developing the SLOLR Facility

As stated previously, the results from the survey show that only six out of 24 RSAs had developed SLOLR facilities in their respective jurisdictions. These facilities use several Sharī'ah-compliant structures, some of which are perceived as highly useful and suitable for developing SLOLR support for IIFS.

There are necessary conditions and supervisory assessments that must be fulfilled prior to developing SLOLR facilities. RSAs may consider the following potential Sharī'ah-compliant structures for SLOLR: *qarḍ ḥasan*, commodity *murābaḥah*, *muḍārabah*, *takāful* and *mushārah*. The uses of structures may vary from simple to complex, depending on the particular RSA.

Four steps are involved in the *qarḍ ḥasan* structure: (a) an illiquid Islamic bank (or IIFS) requests an SLOLR facility from the central bank; which (b) lends (or injects liquidity) under a *qarḍ ḥasan* contract; (c) the IIFS provides good collateral; and (d) repays the principal amount to the central bank upon maturity along with the administrative fee, upon which the collateral is released by the central bank.

On the other hand, the commodity *murābaḥah* SLOLR mechanism comprises six steps. (a) Upon receiving a request, the CB buys Sharī'ah-compliant commodities on a spot basis from Supplier A/Broker A. (b) The CB pays cash on the spot to Supplier A/Broker A for the commodities. (c) The CB sells the commodities to the counterparty using a *murābaḥah* contract (i.e. cost plus profit basis) on a deferred payment basis. (d) The counterparty (IIFS) sells the commodities on the spot to Supplier B/Broker B to obtain funds. (e) The IIFS receives cash from Supplier B/Broker B against those commodities. (f) The IIFS pays the amount of the *murābaḥah* profit plus the original investment through periodic payments to the central bank as agreed by both parties in the contract.

The *muḍārabah* structure consists of five steps: (a) an illiquid IIFS requests an SLOLR facility from the CB; which (b) as the *rabb al-māl* injects liquidity under a *muḍārabah* (profit-sharing and loss-bearing) contract with the IIFS (*muḍārib*) into a pool of funds mixed (or commingled) with the funds of other *rabb al-māl* (IAHs or profit-sharing investment account); (c) the IIFS provides good Sharī'ah-compliant collateral to the CB for any negligence or operational risk; (d) the IIFS invests the pool of funds in Sharī'ah-compliant investment instruments and assets; and (e)



repays the principal amount plus profit earned to the CB as per the agreed profit-sharing ratio, upon which the collateral is released by the CB.

Meanwhile, the *wakālah* SLOLR mechanism operates as follows: (a) an illiquid IIFS requests an SLOLR facility; (b) the CB (*muwakkil*) appoints the IIFS (*wakīl*) as its agent to invest in Sharī'ah-compliant transactions on its behalf; (c) the wakil notifies the CB of the expected profits upon placement of funds; (d) the IIFS invests the pool of funds in the Sharī'ah-compliant investment instruments and assets; and e) any profits exceeding the quoted expected profits will be retained by the IIFS as an incentive.

These potential structures have their own merits and weaknesses. For the RSAs to mitigate the weaknesses when developing SLOLR facilities, this paper recommends that, with appropriate collateral requirements, *qarḍ* could be used for overnight funding, collateralised commodity *murābaḥah* could be used for intraday and short-term funding (i.e. up to one week), and *muḍārabah* or *wakālah* could be used for longer-term (i.e. up to 30 days or more) liquidity provision.

Two potential structures – namely, *takāful* and *mushārah* – have been proposed. The latter is seen as a plausible alternative to solve the problem of *muḍārabah* structure where the central bank as *rabb al-māl* would alone bear losses. Meanwhile, the use of the *takāful* structure for SLOLR was proposed by Chapra and Ahmed.¹⁰ According to the two authors, the structure works similarly to a *takāful* scheme. The model can be structured via setting up a mutual cooperative fund by the central bank to be participated in by the IIFS in their respective jurisdictions. The special fund aims at providing the ELA for the participating banks whenever needed. However, the authors cautioned that the proposed scheme might be controversial from the Sharī'ah perspective because it is viewed as being similar to *qurūḍ mutabāḍalah* (reciprocal loans), which are considered unacceptable by some Muslim jurists, due to their resemblance to the practice of receiving a benefit for a loan extension that is tantamount to *ribā*, in accordance with the following Islamic legal maxim: "Any loan that generates benefits [for the lender] is *ribā*." Nevertheless, the authors cite some other highly respectable Muslim jurists who have allowed this structure, provided that it does not involve the taking and giving of interest.

10 Chapra, M.U. and Ahmed, H. (2006). *Al-Idārah al-Mu'assasiyyah fī al-Mu'assasāt al-Māliyyah al-Islāmiyyah*, (The Islamic Research and Training Institute: Jeddah).



1.6. The Way Forward

The development of an SLOLR is critical in promoting the resilience and stability of the IFSI. The efforts by the supervisory authorities to develop an SLOLR should involve the commercial, private-sector banks and other relevant market participants at the development stage so that any solutions are tailored for the highest level of practicality and usefulness from their point of view. Based on the preliminary results of this paper, there is a need to document the progress of developing SLOLR facilities by RSAs. Further research may result in developing guiding principles for SLOLR mechanisms at a later stage.

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LENDER-OF-LAST-RESORT FACILITIES STRUCTURING SHARĪ'AH-COMPLIANT INSTRUMENTS AND MECHANISMS

Professor Dr. Mohamed Ali Elgari





2.1. Issues under Study

Islamic banking has evolved to the extent that the industry is now able to compete with conventional banks in fulfilling the needs of individuals, businesses and governments by offering a full range of banking services and innovative financing modes that are no less efficient than the alternatives provided by their conventional counterparts and at the same cost. However, the relationship between central banks and Islamic banks remains passive and devoid of any developments even though urgent need dictates otherwise.

It would be of no use to lay the blame on central banks and accuse them of resisting any attempt to adopt special programs that take into account the specificities of Islamic banking. Rather, it can be more fruitful to put forward useful proposals that take into account the parameters within which central banks operate and offer alternatives that can improve some of the central banks' functions that are related to Islamic banking, particularly in regards to the issue of lender-of-last-resort (LOLR) facilities. All of this must be pursued within the scope of what is permissible in Sharī'ah.

This paper presents a proposal in this regard; which can be a starting point for the formulation of a structure that enables Islamic banks to utilise LOLR facilities provided by central banks, without breaching the principles of Sharī'ah.

2.2. Significance of the Study

Developing mechanisms and structures that could enable Islamic banks to benefit from the facilities provided by the central bank in the event of financial shocks is a matter of absolute necessity. Whoever delves into the history of banking will come to realise that the central bank's support of commercial banks is an intrinsic component of the banking system without which that system is doomed to fail. Suffice it to say as evidence of the above that the phrase "lender-of-last-resort" dates back to the year 1797 when Francis Baring¹ mentioned it in one of his writings about the best policy to be adopted by the Bank of England to protect the banking system in the event of a financial shock. This fact shows that the great development that took place in the banking system would not have occurred without the existence of such support from the central bank.

Therefore, the role of the LOLR is one of the most significant functions of the central bank due to its considerable importance in achieving the stability of the banking system in particular and the national economy at large.

1 Sir Francis Baring (1797). *Observations on the Establishment of the Bank of England and on the Paper Circulation of the Country*, (Swell, Cornhill, and Debrett: London).



If we truly aspire to a day when all banks in Muslim-majority nations become Islamic, we have to keep in mind the fact that such a dream would be impossible unless an effective and legitimate formula is developed for the function of LOLR, which is why this issue is so vital.

2.3. Importance of the LOLR in the Realm of Banking

Liquidity is to the economy what the circulatory system is to the human body, and as we know, banks are the main source of liquidity in the economy. It is true that the national currency is issued by the central bank; however, banks remain the source of liquidity. This feature is due to what is called the “fractional reserve system”,² which enables banks to generate liquidity.

Banks retain a limited fraction of their deposits in the form of cash in their vaults or accounts at other banks or with the central bank. As for the most important part of deposits, which may amount to over 90% of total deposits, it will be used for financing, which would generate liquidity since this process will be repeated by all the banks collectively. The role of banks in generating liquidity is irreplaceable and highly essential for achieving economic growth and stability. Thus, the role played by banks in the national economy is extremely vital.

On the other hand, the aforementioned fractional reserve system exposes banks to the risk of default by being unable to fulfil their obligations towards their depositors at all times. At the institutional level, each bank should ensure on a daily basis that the available amount of liquidity is equivalent to the expected amount of withdrawals by its clients on that day. If demand exceeds supply, the bank resorts to “interbank lending”, a method by which it can obtain liquidity from other banks having surplus liquidity on that day. At the system-wide level, the aggregate supply of liquidity must equal the aggregate demand for liquidity for all banks. The interbank lending system serves the purpose of transferring liquidity from one bank to another within the banking sector to achieve the objective of aggregate demand for liquidity equalling the aggregate supply.

However, if aggregate demand at the system-wide level exceeds the aggregate supply of liquidity, the only way out of the crisis is to resort to the central bank for the supply of the necessary liquidity. Therefore, to ensure the soundness of the banking system in the jurisdiction, the central bank must be prepared for such instances at

2 A system where a bank covers a small portion of its liabilities towards its depositors, while lending the larger portion of deposits based on the law of large numbers, which assumes that the volume of liquidity the bank is expected to require on a daily basis would be no more than 5% or so of its total liabilities.



all times. This is applicable in the short term, but in the long term, banks can resort to other sources of funding such as issuing securities of various kinds.

Without these measures, banks would face the risk of failure and collapse at the slightest financial shock. This is because the fractional reserve system depends entirely on the confidence of account holders that they can withdraw, at any time, their deposited money. If this confidence is shaken for any reason, or if depositors have doubt that a certain bank does not have sufficient funds, such uncertainty will turn into panic and will result in a bank run contagion. Consequently, each depositor would expect the worst and fears that if he delays the withdrawal of his deposit he may never be able to retrieve it, as other depositors may have withdrawn their deposits first.

When the assets of a bank can cover all of its liabilities, the bank is solvent. However, most of a bank's assets are illiquid and cannot be sold quickly unless they are sold at a large discount due to the deterioration of their quality because of the stress conditions caused by depositors who are demanding to withdraw their deposits. If a bank buckles under such pressure and sells its assets for low prices, its financial position would worsen and would eventually cause it to fail, as the shortage of liquidity no longer becomes its only problem.

Moreover, in such cases the banking sector suffers from contagion, which means the critical situation of one bank (shortage of liquidity) will spread to other banks unless the issue is immediately treated. If depositors of a certain bank lose confidence in it, they will rapidly influence the depositors of other banks, which would put the entire banking system at the risk of collapse.

Collapse of the banking system leads to the collapse of the national economy. Consequently, this would mean the affected jurisdiction losing its economic fundamentals, which in turn would result in halting economic growth and could even result in deflation, as well as the consequent social unrest, rise of problems of every kind, and so forth. Therefore, it is natural that central banks strive to prevent such an eventuality from happening, by being ever ready to support any bank that is unable to stand its ground, so that its collapse would not result in the collapse of the entire banking system.

2.4. Mechanisms for Performing the LOLR Function

The central bank provides LOLR facilities to banks using various mechanisms, the most important of which are through:



- (a) direct lending, which is the preferred mechanism, and collateralising the high-quality assets of the bank to document the loans, which carry relatively high interest rates; and
- (b) repurchase agreements (repo), which is a contract for the spot sale of securities combined with a deferred contract to repurchase the same securities by the seller at a price higher than the sale price. The difference between the sale and repurchase prices is the interest on the loan and is called the “repo rate”.

The securities that are the subject matter of the aforementioned transaction are debt bonds with a short-term maturity that varies from one day to several days, or possibly weeks.³ A custodian holds the securities to facilitate the transaction and specify any due taxes.⁴

2.5. Why Is It Called “Lender-of-Last-Resort”?

In the normal course of their business, banks always lack liquidity, which they obtain under normal conditions through multiple methods and from different sources. The obtained liquidity is usually sufficient as long as the aggregate supply of liquidity equals the aggregate demand in the economy. Therefore, the primary source of liquidity under normal conditions is the market, whereby a bank can obtain financing through the issuance of long-term securities or by relying on short-term interbank borrowing. If these two avenues are not available, only then does the role of the lender-of-last-resort come into the picture.

The central bank is the institution that plays the LOLR role. However, being ever ready to provide loans may entail a moral hazard, as it may create an incentive for banks to bear more risk than they should and to rely on the willingness of the central bank to lend to them. Therefore, the central bank does not provide liquidity to a bank suffering from illiquidity unless two conditions are satisfied. First, the loans must be guaranteed by collaterals of good quality, which are often the best assets of the bank.

3 Another type that could be available is open repo, which has no maturity date and it can remain in effect till both parties agree to end it.

4 There is also what is known as reverse repo, which is used by the central bank to absorb liquidity from the banking system. However, it is not used when performing the role of the lender-of-last-resort, but for liquidity management by central banks.



Second, the liquidity facilities are offered at a considerably high cost to ensure that the bank demanding liquidity has tried all other possible means before resorting to the central bank. This is because the central bank does not want to be an alternative for interbank lending or any other sources of liquidity, nor does it want to compete with other banks in providing liquidity for each other. This is why it is called the lender-of-last-resort, since only a destitute bank would seek it.

2.6. Sharī'ah Issues Surrounding the Conventional LOLR Scheme

Central banks provide liquidity to banks only through interest-bearing loans, documented by collaterals, or through repurchase agreements (repo) which make use of some of the bank's tradable assets.

- (a) The issue in the first method is the fact that they are interest-bearing loans. Such loans are the exact replica of usury (*ribā*) of the pre-Islamic era of ignorance, which is explicitly prohibited. Islamic banks came into existence specifically to eradicate it. Therefore, Islamic banks cannot be involved in such loans for any reason whatsoever.
- (b) The issue in the second method of repurchase contracts is less severe than the interest-bearing loans, especially if the subject matter of the transaction is permissible shares instead of interest-bearing bonds. However, the two issues of appending the sale transaction to a future date and purchase of the subject matter on condition of its repurchase remain unresolved. These issues will be discussed further later.

Meanwhile, central banks in most jurisdictions find it difficult to adopt alternative schemes dedicated to Islamic banks because they lack a structure that can provide liquidity at the same level of the risk–return spectrum and with the same efficiency in application while at the same time not requiring additional procedures for monitoring and follow-up.

Designing special schemes for Islamic banks that meet all of the above-mentioned requirements is by no means an easy task. The difficulty arises especially from the fact that the circumstances that require quick intervention by the central bank are always very critical, to the extent that they do not allow the involved parties to enter into complex procedures or contracts that need lengthy negotiations, or time to study and assess the potential risks. All these issues are associated with the use of transactions such as cost-plus sale (*murābaḥah*) or joint venture (*mushārakah*).



It is well-known that lending with interest is the easiest way of funding, with the least required procedures and the clearest contract provisions. Therefore, these requirements must be taken into consideration when proposing an acceptable mechanism for Islamic banks.

2.7. Alternative Mechanisms in Islamic Banking Literature for LOLR Facilities

Many studies have discussed the issue of the relationship between the Islamic bank and the central bank, particularly with regard to the LOLR function. Many mechanisms have been proposed, the aim of which is to provide the necessary protection for Islamic banks by creating an appropriate source of liquidity to be resorted to in the event of a financial shock. The most important of those proposed mechanisms are discussed next.

2.7.1. Entering into a Profit-Sharing/Loss-Bearing (*Muḍārabah*) Contract between the Central Bank and the Islamic Bank

A number of researchers have suggested the profit-sharing/loss-bearing mechanism of *muḍārabah* as a way for Islamic banks to obtain liquidity from the lender-of-last-resort. *Muḍārabah* is a profit partnership contract between the provider of capital (*rabb al-māl*) and the entrepreneur (*muḍārib*). Both partners agree to share the profit according to an agreed-upon ratio, while losses are incurred by *rabb al-māl* unless the loss is due to any misconduct or negligence on the part of the *muḍārib*. In the proposed structure, the central bank acts as the *rabb al-māl*, while the Islamic bank acts as the *muḍārib*. Accordingly, if an Islamic bank needs liquidity (in the case of a financial shock), it needs only to sign a *muḍārabah* contract with the central bank whereby it receives the capital of the *muḍārabah* and uses it to meet its liquidity needs. The generated profit is divided between both parties based on an agreed-upon ratio, and the *muḍārabah* would be liquidated at the end of its prescribed term. Even though this proposed structure is acceptable from the Sharī'ah perspective, it has inherent operational shortcomings that would make its application almost impossible. For example:

- (a) The nature of the LOLR function requires that funds provided by the central bank be guaranteed by the beneficiary bank, since the provided funds are considered a debt on its liability. Moreover, the debt must be collateralised. This arrangement is not applicable to the profit-sharing/loss-bearing contract of *muḍārabah*, since the *muḍārib* is not allowed to guarantee either the capital or the profit for the benefit of *rabb al-māl*.



- (b) The rate of return on the liquidity provided by the central bank is usually high. This rate of return is measured in relation to the prevailing interest rates or those that are expected to prevail. However, the *muḍārabah* contract requires sharing of the profit.

2.7.2. The Use of Reciprocal Loans by the LOLR

The proposed mechanism is that the central bank would provide a loan to any Islamic bank that is in need of liquidity. However, the central bank will not be entitled to receive any interest on the loan, since it will be an interest-free loan. At the same time, the Islamic bank is required to extend an interest-free loan similar to the one it has received in terms of amount and duration to the central bank. In some mechanisms, the loan extended by the Islamic bank would be for a longer duration or higher amount than the original interest-free loan. Nevertheless, this mechanism has inherent Sharī'ah and practical issues. In terms of the Sharī'ah issues, the mechanism has the following shortcomings:

- (a) The consensus of jurists is that conditional reciprocal loans are impermissible, while those who did permit such loans stipulated that they should not be conditional. Some Sharī'ah boards, such as Al-Baraka Bank Sharī'ah Board, deemed the use of reciprocal loans permissible, provided that they are based on a promise (*wa'd*).
- (b) The mechanism of reciprocal loans cannot be applied unless a condition for increasing the duration of the loan or its amount is stipulated. Especially taking into consideration the fact that the point in time at which the Islamic bank receives the first loan would be different from the point in time at which the central bank receives the second loan. This requires taking into account the new circumstances that may entail a request to increase the amount of the loan. Therefore, stipulating a condition that the second loan must be of a higher amount or for a longer duration than the first loan is considered a conditional increment that falls under the definition of *ribā* and no jurist has deemed this permissible.
- (c) Even if we assume that the amount of the second loan equals the first one and the duration of both loans are the same, this will not meet the requirement of the central bank that a high return on the loan be given to the Islamic bank. This requirement is needed to ensure that banks will not resort to such a facility except when no other sources of liquidity are available and, as a result, such a requirement cannot be met under this proposed mechanism.



- (d) Usually the central bank provides liquidity to an Islamic bank under stressed conditions, which means it is unfathomable for the Islamic bank that has just received the liquidity injection to have a surplus of liquidity within a reasonable period of time, which can be lent to the central bank for the same duration of the loan it received from it.

2.7.3. The Use of Commodity *Murābaḥah* for the LOLR Function

Under this proposal, the central bank purchases commodities from the market on a deferred payment basis, then sells them to the Islamic bank that needs liquidity on a deferred payment basis. The Islamic bank would then sell the commodities in the market on a spot payment basis to obtain cash to meet its liquidity needs.

In fact, this method is applicable and has already been applied in one central bank. However, it is not expected to be used extensively by other central banks because of the following shortcomings:

- (a) It requires relatively long procedures, while the need for liquidity in the event of a financial shock cannot endure any delays.
- (b) Commodities markets do not have the depth necessary to conduct large operations, which is what the banks usually need. Furthermore, the occurrence of a financial shock in financial markets would also affect the commodities markets.
- (c) A *murābaḥah* contract has a fixed duration, and in cases where a bank needs liquidity for an unknown duration, such a mechanism cannot be applied. However, it is argued that the mechanism can be renewed with a new *tawarruq* transaction. However, the procedures for the new *tawarruq* transaction would be more complex, especially for large amounts of money.

2.8. Proposed Mechanism for the LOLR Function

Certain characteristics must be met in the proposed mechanism for the LOLR function so that it can be an alternative for the conventional mechanism:

- (a) The facility must be efficient, so that it can be applied quickly and using easy procedures.



- (b) The facility must be of a higher cost than other alternatives to ensure that the use of such a facility will not result in any «moral hazards» in the sense that it would tempt the bank to take more risk than it should. The only way to determine the cost of the facility would be to compare it with the cost of the other alternatives, which are usually based on interest rate. Accordingly, we will present below the proposed structure and explain its juristic basis.

2.8.1 New Proposed Mechanism for the LOLR Function

The new proposed mechanism is based on the *muḍārabah* contract. This contract was not given adequate attention in Islamic banking due to the belief that it involves high risk. On the contrary, the *muḍārabah* contract should form the backbone of Islamic banking. It is based on profit sharing between a capital provider *rabb al-māl* and a *muḍārib*, who conducts and manages the business. Scholars of Islamic jurisprudence have defined it as: “A contract whereby an individual gives another a sum of money for the latter to utilise it in trading activities, provided that the profit is shared between them based on what was agreed between them.”⁵

There is no text in the Qur’ān, or the Sunnah of Prophet Muhammad, peace be upon him, that explicitly mentions the contract of *muḍārabah*. However, people used to practise it, so the jurists took great pains to regulate it and set conditions for its validity so it can be conducted in compliance with the rules and principles of Sharī’ah. Furthermore, jurists have dedicated entire chapters in the books of Islamic jurisprudence to the subject of *muḍārabah*. Its famous mechanism is what has been commonly practised in the past, and it has been said that the Companions of the Prophet Muhammad, peace be upon him, had practised this kind of profit-sharing contract since the dawn of his prophethood.

This proposed mechanism is based on entering into a *muḍārabah* contract between the central bank and the Islamic bank that needs liquidity. The mechanism will serve its purpose without the need to resort to interest-bearing loans. At the same time, the *muḍārabah* contract will be designed in a way that would reduce the risks associated with it so that it can be applicable in the current banking system and meet the conditions of the central bank in regards to the function of the lender-of-last-resort.

5 Authored by a group of Sharī’ah scholars (1995). *Al-Mawsū’ah al-Fiqhiyyah al-Kuwaytiyyah*, (Dār al-Şafwah: Egypt). Vol. 33, p. 112.



2.8.2 The *Muḍārabah* Contract Has a Large Degree of Flexibility

The contemporary juristic thinking surrounding the contract of *muḍārabah*, which is reflected in the resolutions of fiqh academies and the pronouncements of Shari'ah boards, did not confine itself to the original mechanism of the *muḍārabah* contract. Rather, it was based on the opinion of Imām al-Shawkānī and what he narrated from Ibn Ḥazm whereby they stated: "No authentic *ḥadīth* of Prophet Muhammad, peace be upon him, mentioned *muḍārabah* contract, except for one weak *ḥadīth* in which he said it has blessing."⁶ Furthermore, Ibn Ḥazm also stated in his book, *Marātib al-Ijmā'*: "All the chapters of jurisprudence have origins in the Qur'ān, and Sunnah except *qirāḍ* [*muḍārabah*] which we could not find any origin of it in the Qur'ān and Sunnah." The contemporary juristic thinking surrounding the contract of *muḍārabah* is best reflected in the following:

- (a) One of the basic principles of the *muḍārabah* contract is that it cannot be limited to a specific duration. Accordingly, the opinion of the Shāfi'ī and Mālikī jurists and one of the opinions of the Ḥanbalī jurists is that fixing a duration for the *muḍārabah* contract would invalidate it.⁷ However, contemporary jurists adopted the opinion of Abū-Ḥanīfah that permitted such a practice and it has become the norm for the *muḍārabah* contract to have a fixed duration.
- (b) Another basic principle of *muḍārabah* is that it is a permissible, non-binding contract. Almost a consensus is held on this point, as stated in *Al-Mughnī*: "*Muḍārabah* is one of the permissible contracts that can be terminated by any of the two parties ... whether before or after work has commenced."⁸ However, contemporary jurists adopted the opinion of the Mālikī jurists, which considers the *muḍārabah* binding if the entrepreneur commences the work. Moreover, they made it binding if a condition to this end is stipulated. Therefore, on this basis the *muḍārabah* contract that is being practised by the Islamic banks is binding on both parties from the moment of signing it.
- (c) Another basic principle of *muḍārabah* is that the capital provider must provide the capital to the entrepreneur in the form of minted dirhams and dinars. In this regard, the classical jurists said: "If the capital provider sets a condition that he will hold the money in his possession and he would pay the price of any item purchased by the entrepreneur, the contract would still become invalid." However, contemporary jurists approved constructive possession by

6 Al-Shawkānī, Muḥammad bin 'Alī (1993). *Na'il al-Aṭwār*, (Dār al-Ḥadīth: Egypt). Vol. 5, p. 300.

7 Ibn Qudāmah, Abū Muḥammad Muwafaq al-Dīn (1968). *Al-Mughnī*, (Maktabat al-Qāhīrah: Cairo). Vol. 5, p. 50.

8 Ibid., Vol. 5, p. 46.



considering the amount of money held in a bank account to be constructively possessed by the bank.

- (d) Another basic principle is that distribution of the profit is juristically valid only after liquidation of the *muḍārabah* venture. Therefore, the entrepreneur does not own a share of the profit unless the profit is distributed. This is in line with what Ibn Qudāmah stated in his book *Al-Mughnī* when he said: “The *muḍārib* is not entitled to receive any portion of the profit until he delivers the capital to the capital provider.”⁹ Nevertheless, the contemporary formula of *muḍārabah* depends entirely on what is called “constructive liquidation” by considering the accounting books in the bank as an acceptable form of evidencing the recognition of profit or loss and whether the capital of *muḍārabah* is impaired or not. This approach relies on a statement that Imām Aḥmad was reported to have said and was quoted by the author of *Al-Mughnī* Ibn Qudāmah who said: “[The outcome of *muḍārabah* can be] calculated as [if the capital] is in the possession [of the capital provider].”¹⁰
- (e) Another principle is that it is impermissible for the capital provider to instruct the *muḍārib* to carry out the *muḍārabah* venture using the debt owed by the *muḍārib* to the capital provider. Such a scenario is impermissible and the *muḍārabah* venture based on it would be voidable. Ibn Rushd stated in his book *Bidāyat al-Mujtahid*: “The majority of jurists such as Mālik, Shafīʿī, and Abū Ḥanīfah are of the opinion that if someone is a creditor of another, it would be impermissible for the creditor to give away his debt to the debtor on the basis of *muḍārabah*.” The author of *Al-Mughnī* also says, “It is impermissible to inform a debtor to trade in the debt owed by him on a *muḍārabah* basis.”¹¹ However, all the *muḍārabah* contracts conducted by Islamic banks for the purpose of investment are based on transforming funds to the investment account from the current account, which is a debt owed by the bank to the customer. Thus, it is as if the customer is saying: “Conduct *muḍārabah* using the amount of debt you owe me”, which contradicts the above-mentioned basic principle and deviates from the consensus of the jurists. The evidence for adopting this opposing view is a juristic opinion of the Ḥanbalī jurists, which was quoted by the author of *Al-Mughnī* when he was discussing the view that prohibited such approach: “Some of our companions stated that the *muḍārabah* could be deemed valid.”¹²

9 Ibid., Vol. 5, p. 41.

10 Ibid., Vol. 5, p. 45.

11 Ibid., Vol. 5, p. 53.

12 Ibid., Vol. 5, p. 53.



From all of the above, it is evident that the *muḍārabah* contract has a great deal of flexibility and broadness, which makes it a convenient answer to the contemporary needs of people. The *muḍārabah* remains permissible unless its inherent nature is affected, which is something that would deem it invalid such as stipulating the guarantee of the capital, since such a condition would turn the *muḍārabah* into *qarḍ* and, as a result, profit from such an arrangement would be a form of *ribā*. Another issue that could affect the legitimacy of *muḍārabah* is when one of the partners claims all of the profit at the expense of the other party despite having a profit-sharing agreement.

2.8.3. The Proposed *Muḍārabah* Structure

An Islamic bank can enter into a *muḍārabah* agreement with the central bank that has the following description:

- (a) The agreement must involve entering into daily *muḍārabah* contracts that enable the Islamic bank to obtain liquidity from the central bank in cases where such liquidity is needed. Whenever the Islamic bank withdraws an amount to cover its shortage of liquidity, this amount is to be considered the capital of a one-day *muḍārabah* contract to be invested by the Islamic bank in its financing activities via the use of Shari'ah-compliant modes of financing. Any profit generated will be shared in accordance with what is stipulated in the agreement. For example, the central bank may have one-third of the profit and the entrepreneur (the Islamic bank) two-thirds, or each party is to have half of the profit, and so on. The percentage of profit sharing may be changed on a daily basis. Moreover, there is no objection to increasing the central bank's share of the profit to prevent the Islamic bank from requesting liquidity unless it is urgently in need of it and cannot obtain it by any other means.
- (b) The aforementioned capital of *muḍārabah* is to be added to the overall working capital of the Islamic bank, which entails the establishment of *mushārah* in the investment pool of the Islamic bank. Hence, the *muḍārabah* capital is entitled to receive a share of the profit equivalent to its percentage in the total *mushārah* capital on that day, which refers to the total investment pool of the Islamic bank.
- (c) At the close of business, the *muḍārabah* is constructively liquidated and profits are shared accordingly. It must be stipulated in the agreement that if the term of the *muḍārabah*, which is one day, expires, the relationship between the central bank and the Islamic bank is turned into a debt-based relationship because the capital of *muḍārabah* becomes a loan on the liability of the Islamic bank. Thus, the amount liquidated on that day, which represents the



capital of *muḍārabah* and any generated profit, would be guaranteed by the Islamic bank.

- (d) Both parties enter into a new *muḍārabah* contract on the next day with the same conditions, and the new capital of *muḍārabah* would be the amount resulting from the constructive liquidation of the *muḍārabah* contract of the previous day. In other words, it would be the capital of the first *muḍārabah* in addition to the profit of the first day, if any. It is also possible for both parties to agree not to distribute the profit on a daily basis, which means the capital of the new *muḍārabah* contract would be the same as that of the first *muḍārabah* contract. Moreover, the central bank may change the conditions of the agreement in regards to the profit-sharing ratio or terminating the agreement at the end of any day.
- (e) At the end of each year (or each quarter), or when the bank is no longer in need of liquidity, and where the agreement between the two parties includes a clause not to reinvest the daily profits, the Islamic bank would calculate the daily accumulated profits and the central bank would receive its capital plus its share of the accumulated profits.

2.8.4. The Profit-Sharing Method

The entrepreneur in the above-mentioned *muḍārabah* contract is the legal personality of the Islamic bank, and such a legal personality comes under the same rules and provisions that apply to a natural person. Therefore, the legal entity of the Islamic bank, its fixed capital, and employees constitute an intrinsic part of it, similar to the case where a man acts as a *muḍārib* by relying on his physical ability, intelligence, shrewdness, and other tools of the business, etc. The working capital of the Islamic bank (the legal personality that is acting as a *muḍārib*) consists of what it spends to accomplish production operations in its field of specialisation, which is financing, and this is the subject matter of the partnership. This is because the *muḍārabah* contract results in the entrepreneur commingling the capital of the *muḍārabah* with his own working capital to enhance its financing activities. Therefore, both parties become partners in the overall investment pool where all the funds are collected. The share of the *muḍārabah* in the realised profit is determined based on the percentage it constitutes of the overall *mushārahah* pool. For example, if the *muḍārabah* capital constitutes 10% of the overall *mushārahah* pool, the profit to be divided between the capital provider and the entrepreneur (i.e. the *muḍārabah* profit) would be 10% of the overall profit of the *mushārahah* pool. Accordingly, the entrepreneur may get two-thirds and the central bank one-third of the said percentage, or based on any agreed-upon profit-sharing ratio.



In this regard, the International Islamic Fiqh Academy, in its resolution no. 30 (304/), stipulated the following: “The amount to be divided is the profit in the juristic sense of the word, which is the amount over and above the capital and not the revenue or yield. The amount of profit is determined by either liquidation or valuation of the project’s assets in cash. Whatever is above the capital at the point of liquidation or valuation is considered the profit, which is to be distributed between the *ṣukūk* holders and the entrepreneur.”

Thus, the entrepreneur has to hand over the capital to its provider and whatever amount over and above the capital is considered the profit in the juristic sense of the word that has to be divided between the partners.

2.8.5. Profit Sharing in Contemporary Companies

How can we apply the profit-sharing rule mentioned above when using the *muḍārabah* contract, bearing in mind that the calculation of profit and other items related to it is governed by the accounting standards and the perception of accountants and auditors to the financial position of companies and the way their accounting books are managed? According to contemporary accounting standards, there are three stages for profit calculation – namely, the calculation of gross profit, operating profit and net profit. Thus, to which one of these three types of profit does the definition of profit according to the rules of *muḍārabah* apply?

Gross Profit

Gross profit (also called “gross margin” or “added value”) equals the total revenues minus cost of sales, or, in other words, the surplus of sales revenues after deducting the cost of production. Accountants consider it the best method for measuring a company’s profitability, ability to optimise the use of its financial resources, and the extent of its power in the face of its competitors. This is because the higher the gross profit is, the stronger it reflects the company’s ability to reduce the prices of its products. On the other hand, a low gross profit indicates the vulnerability of the company’s financial position. Moreover, when the gross profit continues to fall, it would be an indication of the increasing cost of production due to the increase of salaries and wages, or the decline in product quality, or the increase in the prices of raw materials in a faster pattern as compared with the increase in the prices of the product.



Operating Profit

If, for example, the gross income is 420,000 and the cost of sold goods is 210,000, the gross profit would equal 210,000. The gross profit after deducting fixed expenses such as the shop rental, electricity bills, salaries of staff, and so on, would be called the “operating profit”. Therefore, if the gross profit, as in the example above, is 210,000 and fixed expenses equal 100,000, then the operating profit would be 110,000.

Net Profit

Net profit is the operating profit after deducting taxes and interests on loans.

After analysing the types of profit as defined by the accounting standards, we find that the type of profit, which is in line with the resolution of the International Islamic Fiqh Academy and the consensus of classical and contemporary jurists, is the gross profit. It is the total working capital minus the costs of production. The *muḍārabah* capital would be commingled with the entrepreneur’s own working capital, and the realised profit would be the subject of distribution between the entrepreneur and the capital provider. Thus, the *muḍārabah* contracts can be applied within the scope of accredited accounting standards.

2.8.6. Objections and their Refutations

It is Not Permissible for the Entrepreneur to Guarantee the Capital of Muḍārabah

In order for the proposed mechanism to be suitable for performing the LOLR function, the capital of *muḍārabah* must be guaranteed by the entrepreneur at the end of every day. It may be argued that it is impermissible for the *muḍārib* to guarantee the capital or profit for the benefit of the capital provider and that there is a consensus prohibiting such a guarantee. Nevertheless, there are still cases where stipulating the guarantee of capital is permissible. For example:

- (a) If the capital provider stipulates that the entrepreneur must hand over to him the capital, or the part of it that remained after liquidation, yet the entrepreneur does not fulfil this condition, then he would be considered a usurper and, on this basis, he has to guarantee the capital. This is the basic ruling with regard to any trustee who breaches the conditions set by the party entrusting him, such as a trustee refusing to return a deposit. Accordingly, the *muḍārabah* agreement may include a condition that the entrepreneur must hand over the



capital to its provider at the end of each business day, and if the entrepreneur fails to do so, he would be held liable for the capital that he failed to return. On the next day, both parties may enter into a new *muḍārabah* agreement and, as a result, the capital guarantee would no longer stand. In this regard, jurists, may Allah have mercy on them, have stated that it is permissible for a man to inform the usurper of his money to conduct business with the money on the basis of *muḍārabah* according to the profit-sharing ratio agreed between them. The author of *Badā'ī' al-Ṣanā'ī'* said: "If [the capital provider] adds a guaranteed asset under the possession [of a usurper] such as usurped dirhams or dinars, by saying to the usurper: work with what is under your possession on the basis of *muḍārabah* provided the profit is shared equally. [Then such a practice] is deemed permissible according to Abū Yūsuf and Al-Ḥasan Ibn Ziyād, whereas Zufar deems it impermissible."¹³

Ibn Qudāmah, in his book *Al-Mughnī*, also stated: If someone has a usurped wealth under the possession of a usurper and he [asked the usurper to utilise it] based on *muḍārabah*, such an arrangement would be permissible. This is because [the usurped wealth] is that of the capital provider and it is permissible for him to sell it to whoever is able to take it from the usurper, which makes it similar to a deposit... However, whenever [the owner of the usurped wealth requests the usurper] to utilise it based on *muḍārabah*, the guarantee of the usurped wealth will cease to exist the moment they enter into the *muḍārabah* contract, and this is the juristic view of Abū Ḥanifah.»¹⁴

- (b) It may be argued that the assumption of usurpation is somewhat far-fetched in a way that could affect the proposed structure and it is, therefore, preferable not to resort to such an assumption. However, we can still achieve our purpose in another way. It is known that a capital provider is permitted to stipulate a condition requiring the entrepreneur to invest the *muḍārabah* capital for a specific period of time and, once the agreed-upon period is over, the capital would turn into an interest-free loan on the liability of the entrepreneur. Therefore, the central bank may offer the needed liquidity to the Islamic bank in the form of *muḍārabah* capital for a one-day duration. Once the day is over, the amount turns into an interest-free loan under the guarantee of the *muḍārib* since it is a form of debt established on his liability. Evidence for the permissibility of such an arrangement can be obtained from the sayings of several jurists. For example, Ibn Qudāmah says in *Al-Mughnī*: "Muhannā said: 'I asked Imām Aḥmad about a man who has given

13 Al-Kāsānī, 'Alā al-Dīn (1986). *Badā'ī' al-Ṣanā'ī' fī Tartīb al-Sharā'ī'*, (Dār al-Kutub al-Ilmiyyah: Beirut). Vol. 6, p. 83.

14 Ibn Qudāmah, Abū Muḥammad Muwafaq al-Dīn (1968). *Al-Mughnī*, (Maktabat al-Qāhirah: Cairo). Vol. 5, p. 54.



another a thousand to invest it on a *muḍārabah* basis for a month provided that once the month elapses, the amount would become a loan. He said: it is permissible. Then I asked him if the month elapsed and the amount is in the form of goods, he said: when the goods are sold, the money would become a loan.”¹⁵ This statement proves that stipulating such a condition would achieve the intended purpose and it does not have any objections from the Sharīʿah perspective.

It is not Permissible for the Capital under this Structure to be in the Form of Debt

An opponent of such a structure may say that such a mechanism is objectionable since the *muḍārabah* capital turns into a debt by the close of business, which would result in the central bank not being able to enter into a new *muḍārabah* on the following day. This is because the capital of *muḍārabah* would be in the form of debt on the liability of the *muḍārib* and it is known that the capital of *muḍārabah* cannot be a debt. However, this issue has been debated among classical jurists, and the Kuwaiti Encyclopedia of Jurisprudence cited some of the books of the Ḥanbalīs in regards to this issue. Among these citations are the following: “Ḥanbalis are of the opinion that if a capital provider instructed his debtor to utilize the debt he owes on the basis of *muḍārabah*, such an arrangement would be invalid and this is the predominant view of the Ḥanbalī jurists. However, Imām Aḥmad permitted such a practice. Moreover, al-Qaḍī also permitted it on the basis that it takes the form of an agent purchasing the debt from himself on behalf of the principal. He later amended his view, deeming it permissible on the basis that it takes the form of an agent possessing the debt from himself on behalf of the principal. Two narrations have been cited in respect to this issue.”¹⁶

Furthermore, ibn Qudāmah says in *Al-Mughnī*: “It is impermissible to instruct someone who has a debt on his liability to utilise it on the basis of *muḍārabah*. This is the view of Imām Aḥmad and the majority of jurists. Nevertheless, some of our companions are of the opinion that the *muḍārabah* could be valid. This is because if the debtor [who is acting as a *muḍārib*] purchases an item for the *muḍārabah*, he would have purchased it with the consent of the capital provider. In other words, by doing so he would be using the debt as payment to whomever he was permitted to pay it. Hence, the debtor’s liability will be cleared in regards to the debt obligation. It would be similar to the capital provider providing him with an asset and instructing

15 Ibid., Vol. 5, p. 50.

16 Authored by a group of Sharīʿah scholars (1998). *Al-Mawsūʿah al-Fiqhiyyah al-Kuwaytiyyah*, (Dār al-Ṣafwah: Egypt). Vol. 38, p. 50.



him to sell it and invest the proceeds on the basis of *muḍārabah*.”¹⁷ The author of *Al-Inṣāf*, in elaborating the following statement of Ibn Qudāmah: “If the creditor instructs the debtor to invest the debt owed by him on a *muḍārabah* basis, the arrangement would be invalid”, stated the following: “This position is affirmed by Al-Khiraqī... A contrary opinion is that: such an arrangement is valid. Its validity is based on an analogy mentioned in *Al-Muḥarrar* and it is also a possibility attributed to some of the companions [within the Ḥanbalī school of jurisprudence].”¹⁸ All of the above shows that the issue has a certain level of flexibility and if we ascertain the legal reasoning (*illah*) of the prohibition, we will realise that it does not materialise in our case and as we know any ruling revolves around its legal reasoning in its presence and absence.

Those who explicitly mentioned the legal reasoning behind the prohibition of such an arrangement have said that it is because they fear that the debtor could be insolvent. In this regard, Ibn Rushd in *Bidāyatul al-Mujtahid* said: “If someone is indebted to another, it is impermissible for the creditor to ask the debtor to invest the amount of the debt unless this amount is repaid to the creditor. The argument Mālik provided for this view is that the creditor may know the debtor is insolvent, so he resorts to this trick to defer repayment of the debt provided that the debtor should invest it to increase its amount, which falls under the category of prohibited usury.” However, this concept of insolvency is not applicable to Islamic banks.

2.8.7. The Proposed Structure is Not New and is the Backbone of Islamic Banking Activities

The daily *muḍārabah*, which is liquidated constructively at the end of the day, is present and applied in Islamic banks even though this relationship is practised between the client and the Islamic bank. All we have done is to transfer the application of the aforementioned structure to be between the central bank and the Islamic bank, which became its client.

2.9. Repurchase Agreements

The repurchase agreement (repo) is a tool frequently used by central banks to manage the money supply and promote the function of the lender-of-last-resort. We have previously discussed this tool and elaborated on the Sharī'ah issues it raises. However, some modifications can be applied to the structure to make it a

17 Ibn Qudāmah, Abū Muḥammad Muwafaq al-Dīn (1968). *Al-Mughnī*, (Maktabat al-Qāhirah: Cairo). Vol. 5, p. 53.

18 Al-Mardāwī, 'Alā al-Dīn (No date). *Al-Inṣāf*, (Dār Ihyā' al-Turāth Al-'Arabī: Beirut). Vol. 5, p. 431.



successful tool in implementing the LOLR function. These modifications are as follows:

- (a) The central bank may buy Shari'ah-compliant securities from the Islamic bank such as *ṣukūk* or shares, if any, or units in investment funds, or other forms of assets for a spot price that can benefit the Islamic bank in strengthening its liquidity position.
- (b) The Islamic bank may give a binding promise to repurchase the assets sold to the central bank for a price to be determined on the same date that includes a profit, which is the difference between the selling and repurchase prices. This arrangement can also be in the form of a bilateral binding promise between the two parties, as stipulated in the resolution of the International Islamic Fiqh Academy no.157 (17/6), which stated the following:

***"Third:** In cases where a sale contract cannot be effected because the subject matter is not possessed by the seller, and there is a general need to obligate both parties to execute the contract in the future by virtue of the law or international trade norms, as in the case of opening a letter of credit to import goods. In such cases, it would be permissible to make the promise binding on both parties either by legislating it in a law or by both parties agreeing to insert a clause in the agreement making the bilateral promise binding on both parties."*

***"Fourth:** The bilateral binding promise mentioned above does not fall under the ruling of a sale appended to the future bay' al-muḍāf. Therefore, the ownership of the subject matter will not be transferred to the purchaser, nor does its price turns into a debt due on him. Rather, the sale contract will be effected on the agreed upon date via an offer and acceptance."*

***"Fifth:** If one of the parties fails to fulfil the obligations he undertook to perform under the bilateral binding promise, such a party would be legally obliged to fulfil his obligations or bear the actual damages incurred by the other party as a result of not fulfilling his promise (without considering the opportunity cost)."*

In this manner, a central bank can provide liquidity to an Islamic bank facing a shortage of liquidity within the scope of permitted transactions and at the same level of efficiency as in conventional transactions.



2.9.1. Objections and their Refutation

The Proposed Structure is a Form of a Redemption Sale (Bay' al-Wafā')

According to the Kuwaiti Encyclopedia of Islamic Jurisprudence, *bay' al-wafā'* is defined as follows: "The sale [of an asset] provided that whenever the seller repays the price [of the sold asset], the buyer would return the subject matter to the seller."¹⁹ It may be argued that the proposed structure resembles *bay' al-wafā'*. However, whoever contemplates the inner workings of the proposed structure will find it clearly different from *bay' al-wafā'*, which is an arrangement that involves two sale contracts that are not effected at the same time, but one of the two parties gives a unilateral promise of sale or purchase.

The Proposed Structure is a Form of the Prohibited Bay' al-Īnah

According to the consensus of the majority of jurists, it is impermissible for someone to purchase a commodity on a deferred basis and to collude with the seller to repurchase it on a spot basis, which is a practice known as *bay' al-īnah* (a sale and repurchase contract). Whoever contemplates the inner workings of the proposed structure will find that it falls under the category of unconditional sales that does not involve any deferment of payment, which makes it different from *bay' al-īnah*.

19 Authored by a group of Shari'ah scholars (1987). *Al-Mawsū'ah al-Fiqhiyyah al-Kuwaytiyyah*, (Dhāt al-Salāsīl: Kuwait). Vol. 9, p. 48.



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SHARĪ'AH-COMPLIANT ALTERNATIVES FOR THE FUNCTION OF THE LENDER- OF-LAST-RESORT FOR ISLAMIC BANKS FROM THE CENTRAL BANKS

Dr. Oni Sahroni





3.1. Introduction

The lender-of-last-resort (LOLR) is an issue that has not been adequately studied despite its importance and the need for it in the Islamic banking industry. This is because the mechanisms applied in conventional banking for performing the LOLR function are all based on interest-bearing loans. Therefore, there is an urgent need for Shari'ah-compliant alternatives that can resolve the issue of liquidity for Islamic banks.

This research paper attempts to analyse the conventional tools used for performing the LOLR function from the juristic perspective and then introducing Shari'ah-compliant alternatives.

3.2. The Basic Principles of the Lender-of-last-resort

3.2.1. The Concept of Lender-of-last-resort

The lender-of-last-resort is a role played by the central bank whereby it lends licensed banks with interest when they face a shortage in liquidity, which could be due to an increase in the withdrawal rate of deposits by the clients of the bank. The central bank would then intervene by providing liquidity in the form of an interest-bearing loan on the condition that the bank must provide a collateral that is at least equivalent in value to the loan.¹

The lender-of-last-resort is one of the many functions performed by the central bank, which include:

- (a) prescribing and implementing the monetary policy;
- (b) regulating and safeguarding the payment system; and
- (c) managing and monitoring banks

It is important to note that the function of Lender-of-Last-Resort falls under the objective of prescribing and implementing the monetary policy. In this regard, article 11 of Act 23 of 1999 concerning Bank Indonesia states that Bank Indonesia may

1 Act of the Republic of Indonesia Number 23 of 1999 concerning Bank Indonesia. Bordo, Michael D. (1990). "The Lender-of-Last-Resort: alternative views and historical experience", *Economic Review*, Vol. 76, Issue 1, p. 18.



extend financing based on Shari'ah principles to a Bank for a maximum period of 90 (ninety) days to overcome its short term financial difficulty. However, the receiver Bank must guarantee such financing with a high quality and liquid collateral whose value shall be at least equal to the amount of the accepted financing.²

Shortage of liquidity is an issue that any bank is likely to face, and Islamic banks are no exception. It is due mainly to an asset–liability mismatch, which would in turn result in the affected bank having a negative balance in its current account at the central bank. However, the central bank, being the lender-of-last-resort, has the authority to provide loans to the affected banks or to use other mechanisms that do not contradict Shari'ah rules and principles with the aim of overcoming the liquidity shortage.

The LOLR function is regarded as a tool for liquidity management, not as a monetary policy tool. This is because monetary policy tools such as the issuance of loan certificates aim to stabilise prices and such tools are used in open market operations, contrary to the tools of liquidity management.³

3.2.2. Importance of the Lender-of-last-resort

The importance of the lender-of-last-resort is summed up as follows:

- (a) Trust in the banking system and in its resilience is one of the most vital incentives for attracting local and foreign savings, which in turn will assist in achieving the objective of the overall savings policy by utilising such savings in short-term and long-term economic and social development projects. This will also generate a positive influence on the overall financial policy in general.
- (b) When financial institutions, especially banks, face problems of illiquidity and fail to obtain liquidity from any source, panic will set in among the banks' depositors because of losing confidence in the soundness and stability of the banking system. This in turn will lead to depositors withdrawing their deposits, which will result in the reduction of savings, flight of capital, and migration of investments to another country where the banking system is more secure and profitable.⁴

2 Act of the Republic of Indonesia Number 23 of 1999 concerning Bank Indonesia.

3 Bank Indonesia Regulation No. 5/3/PBI/2003 concerning short-term financing facility for Shari'ah banks.

4 Al-Sa'd, Ahmad Mohammad and Heneini, Mohammad Wajih, Alternatives for Lender-of-Last-Resort Facilities for Islamic Banks from the Central Banks, Conference of Islamic Banks, Between Hope and Reality, Department of Islamic Affairs and Charitable Activities, Dubai, 31 May – 3 June 2009, p. 12.



From the perspective of Islamic jurisprudence, the lack of trust by the depositors in a bank that is facing a shortage of liquidity is a harm that must be eliminated. Therefore, Shari'ah-compliant solutions that are in line with the objectives of Shari'ah must be sought in order to eliminate such harm.

3.2.3. Steps for Covering Liquidity Shortage

As the name suggests, the lender-of-last-resort is the very last mechanism that can be relied upon to manage a shortage of liquidity. Therefore, an Islamic bank or Islamic "window" facing a liquidity shortage must take several steps before resorting to borrowing from the central bank. These steps are as follows:

- (a) The Islamic bank can sell some of its securities to other banks in the Islamic money market to obtain the funds necessary for covering its shortage of liquidity.
- (b) The Islamic "window" can request financing from its parent conventional bank to cover its liquidity shortage.
- (c) The bank may sell its securities to the central bank, the lender-of-last-resort.⁵

As shown above, the first and second steps can be implemented by Islamic banks, or between Islamic windows and their parent conventional banks. If these two steps fail, the bank resorts to the third step – namely, seeking support from the lender-of-last-resort, the central bank.

3.2.4. Conventional Tools of the Lender-of-last-resort

There are three tools that can be utilised in conventional banking to cover the shortage of liquidity, as described below:

- (a) The bank facing the liquidity shortage may sell its securities to the central bank, provided that the bank repurchases such securities from the central bank later on the same day. This method is prevalent among conventional banks, and is considered the first step that can be used by a conventional bank to cover its liquidity shortage.
- (b) Short-term financing, which is offered via a loan provided by the central bank to the bank facing the liquidity shortage, provided that the latter repays the

5 Act of the Republic of Indonesia No. 23 of 1999 concerning Bank Indonesia.



loan within a maximum period of 14 days from the date of concluding the loan contract.

- (c) Emergency financing, whereby the central bank provides a loan to the bank experiencing a shortage of liquidity that could harm the entire banking system if not treated immediately.⁶

The above-mentioned tools represent the mechanisms that can be applied by the central bank to perform the LOLR function. They all involve rediscounting and direct lending. Rediscounting is a vital tool for performing the LOLR function and has become the norm in several jurisdictions except in exceptional circumstances. As for direct lending, it involves offering a loan on the basis of a fixed interest rate different from the rediscount rate and without linking the interest rate on the loan with the rediscount rate of the securities.

The nature of the lender-of-last-resort tools is not in line with the mechanisms of Islamic banks. This is because the LOLR function is performed using two main mechanisms – namely, the rediscount rate or the prevalent interest rate – and both mechanisms fall under the category of *ribā*, which is strictly forbidden in Shari'ah according to authentic and explicit texts, such as the following verses in the Qur'an:

- "Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, 'Trade is [just] like interest.' However, Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] – those are the companions of the Fire; they will abide eternally therein." (Al-Baqarah: 275)
- Allah Almighty also says in the Qur'an: "O you who have believed, fear Allah and give up what remains [due to you] of interest, if you should be believers." (Al-Baqarah: 278)
- In a third verse, Allah Almighty also says in the Qur'an: "O you who have believed, do not consume usury, doubled and multiplied, but fear Allah that you may be successful." (Al 'Imrān: 130)

6 Bank Indonesia Regulation No. 5/3/PBI/2003 concerning the short-term financing facility for Shari'ah banks; Bank Indonesia Regulation No.10/31/PBI/2008 concerning emergency liquidity assistance for Shari'ah bank. Ramlan et al. (2013). Collections of Resolutions from Bank Indonesia ("BI") on Liquidity, (BI Research Center: Jakarta).



Furthermore, the Islamic legal maxim states: any loan that derives stipulated benefit is considered usury. Therefore, the aforementioned verses of the Qur'ān, along with the legal maxim, prove that Sharī'ah forbids *ribā*. Moreover, there is a consensus among jurists that *ribā* is forbidden and no jurist has gone against this consensus.⁷

The importance of the relationship between the central banks and Islamic banks stems from the supervisory role performed by the former in ensuring the resilience of Islamic banks, monitoring their financial position and guaranteeing the rights of the account holder. Therefore, there is a need to devise tools that can perform the LOLR function and are not only Sharī'ah-compliant but also able to fulfil the need for liquidity by the Islamic banks.

3.3. Alternatives for Performing the LOLR Function

3.3.1. Alternative 1: Repurchase Agreements

One Sharī'ah-compliant alternative for performing the LOLR function is the repurchase agreement. The repurchase agreement is a process whereby the Islamic bank that needs liquidity sells its securities to the central bank and promises to repurchase them. The bank must also provide collaterals to the central bank.

In other words, if an Islamic financial institution is in need of liquidity, it may sell securities, such as *ṣukūk* or shares, on a cash basis. The ownership of the sold securities is completely transferred from the Islamic financial institution to the purchaser to enable it to practice all of its legal rights that were accorded to it because of owning the securities. The sale contract shall include a unilateral promise on the part of the purchaser to resell the securities to the original owner within a fixed period.⁸

Based on the above, the Islamic bank that is in urgent need of liquidity can sell its available assets for its current or market price to the central bank or another party, provided that the central bank can benefit from the purchased assets and the income they generate for an agreed upon period. As for the Islamic bank, it can benefit from the price of the sold assets in resolving its liquidity need and if the Islamic bank pays back the price of the sold assets to the central bank, the assets can be returned to it. However, a repurchase agreement may resemble redemption

7 Al-Masri, Rafiq Yunus (1991) *Al-Jāmi' fī Uṣūl al-Ribā*, (Dār al-Qalam: Damscus; al-Dār al-Shamiyyah: Beirut). 1st edition, pp. 250-254.

8 Al-Shubāīlī, Yūsuf (No date). "Tools for Liquidity Risk Management: Tools and Repurchase Agreement Alternatives for Islamic Financial Institutions", p. 14-15.



sale (*bay' al-wafā'*) and buy back sale (*bay' al-īnah*), which were both prohibited by the majority of jurists. In this regard, the majority of jurists prohibited *bay' al-wafā'* and the international Islamic Fiqh Academy issued resolution no. 66 (4/7) regarding its prohibition in which it stated that *bay' al-wafā'* is "the sale of an asset provided that whenever the seller paid back the price of the asset the purchaser would return the subject matter to the seller". The resolution also established that the essence of this sale is (a loan that derives a stipulated benefit) and hence it is a circumvention of the prohibition of *ribā* and the majority of jurists are of this opinion. Therefore, this contract is not permissible from Sharī'ah perspective.⁹

Moreover, the majority of jurists are of the opinion that *bay' al-īnah* is prohibited as well. Ibn 'Umar, may Allah be pleased with both reported that Prophet Muhammad said: "When people stingily withhold every dinar and dirham, make *bay' al-īnah* prevalent among them, follow the tails of cows, and forsake fighting in the cause of Allah, Allah will punish them by trials and afflictions till they return to their religion."¹⁰

Consequently, some jurists set three conditions for the validity of this type of contract so that it may not fall under the categories of *bay' al-wafā'* and *bay' al-īnah*. These conditions are discussed below.

The Sale Must be Real and not Fictitious

A real sale transaction must take place between the seller (the bank needing liquidity) and the purchaser (the central bank). As a result, the sale contract between the two parties cannot be fictitious. The pillars and conditions of the sale contract must be fulfilled, as well as its objectives, such as transfer of the ownership of the subject matter from the balance sheet of the seller to that of the purchaser and the passing of sufficient time between the first and second contract.

Al-Ḍardīr stated in *Al-Sharḥ al-Kabīr* regarding the above-mentioned matter: "[If it changed] i.e. the sold and valued commodity [substantially], at the time of its repurchase like an increase or decrease in its weight then all forms of sale would be valid."¹¹

If the sale agreement was concluded between the bank and the central bank along with a promise to repurchase without the transfer of the associated rights and obligations, such an arrangement would be invalid. On the other hand, if the actual

9 International Islamic Fiqh Academy resolution no. 66 (4/7), seventh session convened in Jeddah Kingdom of Saudi Arabia from 7-12 Dhī al-Qi'dah 1412 corresponding to 9 -14 May 1992.

10 Aḥmad bin Ḥanbal (1995). *Musnad Imām Aḥmad*, (Dār al-Ḥadīth: Cairo). ḥadīth no. 4593.

11 Aḥmad Al-Ḍardīri (No date). *Al-Sharḥ al-Kabīr*, (Dār al-Fikr: Beirut). Vol. 3, p. 82.



sale was effected in the first contract along with a promise to repurchase, then such an arrangement will not fall under the category of the prohibited *bay' al-ṭinah*. This is because the legal reasoning for prohibiting *bay' al-ṭinah* is due to the conditionality of the contract and its use as a method for circumventing the prohibition of *ribā*, and both matters do not apply here.

There Must be a Bilateral Promise between the Buyer and the Seller

A sale contract with a promise to repurchase between an Islamic bank and the central bank passes through three stages:

- (a) The bank sells its securities to the central bank on a cash basis.
- (b) A bilateral promise is made between the seller and purchaser that the Islamic bank will later repurchase the securities from the central bank.
- (c) The Islamic bank repurchases the securities from the central bank on a cash basis.

Some may argue that having a bilateral promise is invalid, since such an arrangement would be similar to a sale contract and it would fall under the category of selling what you do not own, which is prohibited in the Sharī'ah. To answer this, the International Islamic Fiqh Academy of the Organization of Islamic Cooperation has permitted bilateral promise in exceptional and special situations. The resolution states as follows:

- (a) The original ruling concerning bilateral promise is that fulfilling such an arrangement is obligatory from a religious perspective, and not from a legal perspective.
- (b) A bilateral promise between two parties is a way of circumventing the prohibition of *ribā*. This is similar to collusion between two parties with the intent to perform *bay' al-ṭinah* or combine a sale with a loan, both of which are prohibited in Sharī'ah.
- (c) In cases where a sale contract cannot be effected because the subject matter is not possessed by the seller, and there is a general need to obligate both parties to execute the contract in the future by virtue of the law or international trade norms, as in the case of opening a letter of credit to import goods, it would be permissible to make the promise binding on both parties either by legislating it in a law or by both parties agreeing to insert a clause in the agreement making the bilateral promise binding on both parties.



- (d) The bilateral binding promise mentioned above does not fall under the ruling of a sale appended to the future *bay' al-muḍāf*. Therefore, ownership of the subject matter will not be transferred to the purchaser, nor does its price turn into a debt due on him. Rather, the sale contract will be effected on the agreed-upon date via an offer and acceptance.
- (e) If one of the parties fails to fulfil the obligations he undertook to perform under the bilateral binding promise, such a party would be legally obliged to fulfil his obligations or bear the actual damages incurred by the other party as a result of not fulfilling his promise (without considering the opportunity cost).¹²

The (Second) Sale Contract Must be Concluded Based on the Market Price or the Agreed upon Price

The bank facing a liquidity shortage has to repurchase the securities from the central bank (the second contract) on a cash basis based on the prevalent market price or the agreed-upon price. This is because if the bank used the wholesale price in its promise to purchase or sell, then such a price can be either higher or lower than the market price. In cases where it is higher, then the transaction falls under the category of interest-bearing loans. On the other hand, if it is lower than the market price, it becomes similar to *bay' al-wafā'*. Both are prohibited in Sharī'ah.¹³

The above-mentioned mechanism has been applied in Indonesia whereby the Islamic bank in need of liquidity would enter into a sale contract with the central bank to sell what it owns of the sovereign *ṣukūk* with a promise to repurchase them after the ownership of the *ṣukūk* has been transferred from the Islamic bank to the central bank. Such a mechanism is known as Repo.¹⁴

It is important to note that this transaction is not conducted through the commodities market or the secondary market in the exchange. Rather it is conducted through direct sale. Moreover, this alternative has many advantages in the sense that the central bank can rely on it in times of liquidity crisis.

12 International Islamic Fiqh Academy resolution no. 157 (17/6), seventeenth session convened in Amman Kingdom of Jordan from 28 Jumādā al-Ūlā to 2 Jumādā al-Ākhirah 1427 corresponding to 24-28 June 2006.

13 Resolution of the National Sharī'ah Board, Indonesia, No. 94/DSN-MUI/2014 concerning repo (repurchase agreements).

14 Department of studying the securities market at Bank Indonesia, parameters of Repo transaction between the central bank and the Islamic bank, p. 7.



3.3.2. Alternative 2: Financing Based on *Muḍārabah*

With this mechanism, the central bank offers liquidity to an Islamic bank that needs it based on a *muḍārabah* contract. The funds provided to the Islamic bank can be treated as either an unrestricted or restricted investment. The actual profit generated during the period when the funds have been utilised by the Islamic bank is distributed according to the agreed-upon profit-sharing ratio. The Islamic bank would benefit from its share of the generated profit in fulfilling its liquidity need. However, the facility must be given for a sufficient time to enable the Islamic bank to invest the facility and generate actual return.¹⁵

Based on the above, the central bank can utilize this mechanism by providing funds in the form of unrestricted or restricted investment deposits for a specific period in return for an expected profit margin and the use of profit rate instead of interest rate so that the former becomes the main driver for the supply and demand of money. Furthermore, this mechanism could also be a policy adopted by the central bank and as a result, the central bank should accept the idea of profit sharing and loss bearing as envisaged by the concept of *muḍārabah*.

Bank Indonesia adopted this mechanism in its regulation No. 5/3/PBI/2003 concerning short-term financing facilities for Islamic banks. Under this mechanism, Bank Indonesia would be the capital provider and the bank facing the liquidity shortage would be the entrepreneur. This mechanism would enable the Islamic bank to utilise its share of the profit in meeting its liquidity need. It is recommended that the *muḍārabah* be short-term in nature to suit the bank's daily need for liquidity, whereby the capital of the *muḍārabah* would be transferred to the Islamic bank in the morning and the profits would be shared between the Islamic bank and the central bank at the end of the business day.

This *muḍārabah* mechanism is permissible from a Shari'ah perspective as long as its pillars and conditions are duly met. The fact that it will be for short duration does not contradict the rules and principles of *muḍārabah*.

15 Al-Sa'd, Ahmad Mohammad; Heneini, Mohammad Wajih, "Alternatives for Lender-of-Last-Resort Facilities for Islamic Banks from the Central Banks", op. cit., p. 21. Heneini, Mohammad Wajih (2010). "Options of Lender-of-Last-Resort and the Islamic banks (the problem, the dimensions and solutions)", *Journal of Studies of Management Sciences*, Vol. 37, Issue no. 1, p. 123.



3.3.3. Alternative 3: Providing Interest-Free Loans from the Central Bank to Islamic Banks

The central bank may offer financing to an Islamic bank in the time of a financial crisis in the form of interest-free loans (*qarḍ*) based on the idea of (reciprocal deposits with the central bank) to benefit from the liquidity surpluses based on agreed upon conditions between the two parties. For example, the central bank would require the Islamic bank to place a deposit equivalent in value to the one it received from the central bank and for the same term after the Islamic bank overcomes the liquidity crisis it encountered. Therefore, we can name this mechanism (reciprocal deposits) or (reciprocal loans) through which the central bank would be able to provide the needed liquidity to the Islamic banks.¹⁶

However, there is a need to study this proposal thoroughly to make sure it complies with the rules and principles of Shari'ah, especially taking into consideration that the *qarḍ* mechanism suits the nature of Islamic banks' need for liquidity, since the *qarḍ* facility is given based on benevolence.

On the other hand, the *qarḍ* facility may not be compatible with the established traditions of the banking system, which would entail high costs because of implementing this mechanism.

Another aspect that has to be analysed is whether or not the mechanism of reciprocal loans that involves the central bank requiring the Islamic bank to place with it an interest-free loan of the same value and for the same duration falls under the category of a loan that begets a benefit for the lender.

It is crucial to reconsider the Shari'ah compliance of this alternative mechanism that is based on conditional lending by taking into consideration the fact that the jurists have unanimously agreed that any loan with a condition of excess in repayment is impermissible.¹⁷ Ibn-Qudāmah said in this regard: "Any loan provided on condition of receiving excess in repayment is unanimously prohibited." Ibn al-Mundhir also said: "[Jurists] unanimously agreed that if a lender stipulates an increase or a gift on the borrower and he provides the loan on this basis, then receiving such an increase on the loan would be *ribā*."¹⁸

16 Al-Sa'd, Ahmad Mohammad; Heneini, Mohammad Wajih, "Alternatives for Lender-of-Last-Resort Facilities for Islamic Banks from the Central Banks", op. cit., p. 24. Heneini, Mohammad Wajih, "Options of Lender-of-Last-Resort and the Islamic banks: the problem, the dimensions and solutions", op. cit., p. 124.

17 Al-Siddiq al-Ḍarīr (2003). "Awards and Incentives Associated with Bank Accounts", research paper submitted to al-Baraka Annual Symposium on Islamic Economy, p. 65.

18 Ibn Qudāmah, Abū Muḥammad Muwafaq al-Dīn (1968). *Al-Mughnī*, (Maktabat al-Qāhirah: Cairo). Vol. 4, p. 240.



3.3.4. Alternative 4: Establishing a Joint Fund between Islamic Banks

This mechanism is based on concluding an arrangement between Islamic banks where each bank undertakes to place a contribution, the value of which is agreed upon and is taken from its shareholders to be placed in the joint fund. The collected contributions can then be offered in the form of *qard* to any of the fund's member banks that face a temporary deficit of liquidity.

Based on the above, the funds used to cover the liquidity shortage are not taken from the deposits of savings and current account holders or investment account holders. Rather, they are taken from the shareholders' fund. This is contrary to what some researchers proposed who suggested that the source of collected funds could be taken from current accounts. The reason for not collecting the funds from such accounts is the fact that they are a form of *qard* on the liability of Islamic banks and eventually they have to be paid back to the account holders. This makes it difficult to deposit such funds in a joint fund, the purpose of which is to cover the liquidity shortage of its member Islamic banks. Therefore, it is more suitable for the source of funds for such a joint fund to be the shareholders of the participating Islamic banks.

It would be appropriate to formulate criteria based on which the short-term interest-free loans are given to the affected member institutions. The criteria should include measures to determine the magnitude, duration and causes of the liquidity shortage and whether assistance is needed from the joint fund to resolve the shortage. The role of ensuring the sound implementation of this mechanism can be implemented by the central bank or by a committee representing the member institutions that established the joint fund.¹⁹

I believe this mechanism has its origins in the idea of cooperation, which is centred on the concept of *al-naḥd* as applied in Islamic cooperative insurance companies. Therefore, evidence for the permissibility of this mechanism may be sought in the resolution of the International Islamic Fiqh Academy No. 9 (2/9) [1]: "The contract that best complies with Shari'ah rules and principles is that of cooperative insurance, which is based on donation and cooperation."²⁰

19 Al-Sa'd, Ahmad Mohammad; Heneini, Mohammad Wajih, "Alternatives for Lender-of-Last-Resort Facilities for Islamic Banks from the Central Banks", op. cit., pp. 23-24; Heneini, Mohammad Wajih, "Options of Lender-of-Last-Resort and the Islamic banks: the problem, the dimensions and solutions", op. cit., p. 124.

20 International Islamic Fiqh Academy resolution no. 9 (2/9) [1], second session convened in Jeddah Kingdom of Saudi Arabia from 10-16 Rabī' al-Awal 1406 corresponding to 22-28 December 1985.



3.4. Conclusion

The conventional tools for performing the function of the lender-of-last-resort fall under the category of prohibited *ribā*. Nevertheless, they are of great importance to the stability of Islamic banking, since if there are no available Shari'ah-compliant LOLR tools, the confidence of the depositors will be lessened and this may cause a contraction in the volume of deposits and the flight of capital to another country. Therefore, the following Shari'ah-compliant alternatives are proposed:

- (a) Repurchase agreements, whereby the bank needing liquidity would sell its securities to the central bank along with a binding promise to repurchase the securities from the central bank.
- (b) Financing on a *muḍārabah* basis, whereby the central bank offers the required liquidity to an Islamic bank on a *muḍārabah* basis and the Islamic bank utilises the generated profit to meet its liquidity needs.
- (c) Providing interest-free loans by the central bank to the illiquid Islamic bank in accordance with certain conditions agreed upon by both parties. Such conditions include the stipulation to place a deposit with the central bank whose value is equivalent to that the Islamic bank received and for the same duration.
- (d) The establishment of a joint fund whereby each Islamic bank undertakes to place a contribution the value of which is agreed upon and is taken from its shareholders, the collected contributions would then being offered in the form of *qarḍ* to any of the fund's member banks that face a temporary deficit of liquidity.



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- International Islamic Fiqh Academy resolution no. 157 (17/6), seventeenth session convened in Amman Kingdom of Jordan from 28 Jumādā al-Ūlā to 2 Jumādā al-Ākhirah 1427 corresponding to 24-28 June 2006.
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THE ROLE AND MECHANISMS OF SHARĪ'AH-COMPLIANT DEPOSIT INSURANCE SCHEMES: A SUMMARY OF RELEVANT DISCUSSIONS FROM THE IFSB WORKING PAPER (WP-06)*

* The IFSB's Working Paper No. 6 was issued in March 2016 and prepared by Syed Faiq Najeeb and Madaa Munjid Mustafa in consultation with Peter Casey.



4.1. Introduction

A series of crises and volatilities in the global financial and economic systems resulted in several bank failures in the past decade. These have ignited interest in financial safety nets – in particular, deposit insurance schemes (DIS). With an appropriate DIS in place, among other arrangements, customer confidence tends to increase and it becomes relatively easy to manage the financial crisis.

The Islamic Financial Services Board (IFSB) has, since 2010, stressed the need for financial safety net arrangements in the Islamic financial services industry (IFSI). This is also in view of the rapid global expansion of the IFSI, whose worth was estimated at USD1.87 trillion in 2015.¹

The IFSB Strategic Performance Plan 2012–2015 required the Secretariat to conduct cross-border studies in the IFSI, including a study on Sharī'ah-compliant deposit insurance schemes (SCDIS). The findings of the study were eventually published in a working paper (WP). It is worth noting that, since 2010, the IFSB has held several Islamic Financial Stability Forums on financial safety nets, including Sharī'ah-compliant lender-of-last-resort (SLOLR), SCDIS, insolvency regimes and crisis management.

The implementation of a well-designed SCDIS is particularly challenging given the specificities of the Sharī'ah contracts and funding structures of institutions offering Islamic financial services (IIFS). Nonetheless, SCDIS has potential to promote stability and resilience in the IFSI as it enhances depositor² confidence during times of economic shocks and general market stress. Such confidence is critical in preventing panic-induced bank runs that may lead to failures of otherwise profitable IIFS.

The WP aims at achieving three objectives – namely, to establish the significance of SCDIS in enhancing confidence of fund providers in the Islamic banking sector; to review the existing models and practices of SCDIS in different jurisdictions; and to identify major Sharī'ah and operational challenges in developing SCDIS. The following is a summary of the important discussions included in the WP.

1 Source: IFSB Islamic Financial Services Industry Stability Report 2015.

2 The paper clarifies its position that it terms “Islamic deposits” as those funds placed with IIFS on the basis of Sharī'ah contracts of *wadī'ah*, *qard* and *murābahah*, while funds placed on the basis of *wakālah* and *muḍārabah* are referred to as “investment accounts”.



4.2. Conceptual Framework of the Deposit Insurance Scheme

This section reviews the literature on the concept of DIS, its historical evolution, effectiveness, structural design and related post-crisis regulatory development.

DIS is considered one of the essential components of financial safety nets established to promote financial stability and to protect small savers from losses in the case of a troubled or failing bank.³ The origins of national DIS can be traced to the former Czechoslovakia, which in 1924 was the first country to establish a nationwide deposit scheme in order to revitalise the country's banking system after the ravages of World War I. The United States was the second country when, under the Banking Act of 1933, the US government created in June 1933 the Federal Deposit Insurance Corporation (FDIC). The establishment of the FDIC was a direct consequence of the extensive bank runs and thousands of bank failures in the 1920s and early 1930s that contributed to the Great Depression in the US.⁴ It was not until the 1980s, following the collapse of the Bretton Woods System, the rise of financial globalisation and increased volatilities, that there was accelerated interest globally among policymakers in both OECD and developing countries in adopting DIS in their jurisdictions. The ensuing period in the 1980s and 1990s witnessed occurrences of banking and financial crises globally that led to increased demands for insurance protection against systemic events and resulting bank runs.⁵ By 1995, a total of 49 countries offered explicit DIS. That number increased to 87 by 2003.⁶ The International Association of Deposit Insurers (IADI) reported that in October 2014, a total of 113 jurisdictions had instituted some form of explicit deposit insurance and another 40 jurisdictions were studying or considering the implementation of an explicit DIS.

Despite the widespread acceptance of DIS, economists hold two opposing views about its effectiveness. The first view asserts that DIS as policy tools can reduce the likelihood of bank runs.⁷ In contrast, the second view argues that DIS induces

3 IADI (2015). "Deposit insurance systems governing statutes: Facts and figures", International Association of Deposit Insurers, www.iadi.org/di.aspx?id=66, last accessed 27 November 2015.

4 Demirgüç-Kunt, A., and Detragiache, E. (2002). Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation, *Journal of Monetary Economics*, Vol. 49, No. 7, pp. 1373-1406.

5 Ibid., Vol. 49, No. 7, pp. 1373-1406.

6 Demirgüç-Kunt, A., Kane, E. and Laeven, L. (2008). "Determinants of deposit-insurance adoption and design", *Journal of Financial Intermediation*, Vol. 17, pp. 407-438.

7 Hoggarth, G., Jackson, P. and Nier, E. (2005). "Banking crises and the design of safety nets", *Journal of Banking and Finance*, Vol. 29, pp. 143-159.



moral hazard incentives that encourage banks to increase the risk of default due to their limited liabilities or the assurance that depositors' funds are guaranteed.⁸

The proponents argue that DIS is an optimal policy in a situation of panic-induced bank runs that can spread contagiously throughout the entire financial system. Under such conditions, introducing other measures – such as regulatory suspensions (or moratoriums) on bank withdrawals, for example – can leave some depositors in need of liquidity, leading to other potential economic and social problems.⁹ Therefore, in the interest of protecting national payment and credit systems from contagious bank runs, policymakers favour deposit insurance as a means to reduce the likelihood that one bank's distress will cause a full-fledged banking crisis.¹⁰

On the other hand, opponents of DIS doubt its effectiveness. They argue that practically all experts acknowledge that DIS is a source of moral hazard, as the protected bank's ability to attract deposits no longer reflects the risk of its asset portfolio.¹¹ Furthermore, this view argues theoretically that when banks are subject to the threat of a bank run, they may behave more prudently as compared to when the threat was removed by a comprehensive DIS.¹² In other words, DIS may reduce the link between a bank's risk of default and its funding cost, creating an incentive for the bank to increase default risk at the expense of depositors or the deposit insurance fund.¹³ As a result, DIS encourages banks to finance high-risk, high-return projects and this may lead to more bank failures.¹⁴

Empirical studies could be used to review and validate one or other of these opposing theoretical views on DIS. However, empirical studies have only recently begun to be conducted on the effectiveness of DIS, largely due to the lack of necessary data, and the results of these studies are often inconsistent. For example, an empirical study on a sample of 61 countries that had experienced 40 systemic banking crises over

8 Angkinand, A. (2009). "Banking regulation and the output cost of banking crises", *International Financial Markets, Institutions and Money*, Vol. 19, pp. 240–257.

9 Chari, V. and Jagannathan, R. (1988). "Banking panics, information, and rational expectations equilibrium", *Journal of Finance*, Vol. 43, pp. 749–761.

10 Angkinand, A. (2009). Banking regulation and the output cost of banking crises, op. cit., Vol. 19, pp. 240–257.

11 Demirgüç-Kunt, A., and Detragiache, E. (2002). "Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation", op. cit., Vol. 49, No. 7, pp. 1373–1406.

12 Hoggarth, G., Jackson, P. and Nier, E. (2005). "Banking crises and the design of safety nets", op. cit., Vol. 29, pp. 143–159.

13 Merton, R. (1977). "An analytical derivation of the cost of deposit insurance loan guarantees", *Journal of Banking and Finance*, Vol. 1, pp. 3–11.

14 Kane, E. (1989). *The S&L Insurance Mess: How did it Happen?*, (Urban Institute Press: Washington, D.C.).



the period 1980–97 found that explicit deposit insurance tends to be detrimental to bank stability, especially where bank interest rates have been deregulated and the institutional environment is weak. This implies that where institutions are performing well, the opportunities for moral hazard are limited, and effective prudential regulation and supervision can offset the adverse incentives created by deposit insurance. The study also reveals that the impact of deposit insurance on bank stability tends to be stronger the more extensive is the coverage offered to depositors, where the scheme is funded, and where it is run by the government rather than by the private sector.¹⁵ In another study, affirms that a high coverage by DIS is associated with relatively small output losses of crises, presumably due to DIS preventing bank runs once a crisis occurs.¹⁶

In contrast, supported the moral hazard hypothesis. His findings indicated that complete DIS distorts the incentive structure of commercial banks and thus prevents the proper functioning of the market discipline mechanism and leads to excessive risk taking. His study on Turkish commercial banks revealed that these banks showed significant increases in foreign exchange position risk and deterioration in capital adequacy relative to their benchmark after the introduction of the full DIS.¹⁷

The inconsistent empirical results could be due to a considerable cross-country variation in the presence and design features of DIS as revealed by the World Bank database.¹⁸ Several studies argue that these structural differences could potentially impact the effectiveness of DIS and could be socially counterproductive if the system is not appropriately structured.¹⁹ Hence, it may be useful, to reinforce the deposit insurance function with supervisory powers.²⁰ Another study also highlighted that regulation and supervision can control the moral hazard problem by designing an insurance scheme that encompasses appropriate coverage limits, scope of coverage, co-insurance, funding, premium structure, and management and membership requirements.²¹

15 Demirgüç-Kunt, A., and Detragiache, E. (2002). "Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation", op. cit., Vol. 49, No. 7, pp. 1373-1406.

16 Angkinand, A. (2009). "Banking regulation and the output cost of banking crises", op. cit., Vol. 19, pp. 240–257.

17 Müslümov, A. (2005). "Full deposit insurance and the moral hazard problem: the case of the Turkish banking system", *Review of Social, Economic and Administrative Studies*, Vol. 19, pp. 127-144.

18 World Bank (2005). "Deposit insurance around the world: A comprehensive database", *World Bank Policy Research, Working Paper 3628*, (World Bank: Washington, D.C.).

19 Cull, R., Senbet, L. and Sorge, M. (2005). "Deposit insurance and financial development", *Journal of Money, Credit and Banking*, Vol. 37, No. 1, pp. 43–82.

20 Kahn, C. and Santos, J. (2005). "Allocating bank regulatory powers: Lender-of-Last-Resort, deposit insurance and supervision", *European Economic Review*, Vol. 49, pp. 2107–2136.

21 Barth, J., Caprio, G. and Levine, R. (2004). "Bank regulation and supervision: What works best?", *Journal of Financial Intermediation*, Vol. 13, pp. 205–248.



Based on the above discussion, deposit insurance structural design appears to be an important dimension that can potentially impact the effectiveness of DIS. Designing a bank safety net structure is challenging. Policymakers need to strike a balance. They have to ensure that the DIS framework enables market discipline and prevents bank runs. Overly generous DIS increases incentives for excessive bank risk taking, which has been the root cause of many bank failures.²² The literature generally classifies DIS structures into three types: (1) an explicit DIS with unlimited coverage; (2) an explicit DIS with limited coverage; and (3) no explicit DIS (possibly an implicit scheme).²³

Most explicit DIS is in the form of insurance funds that may be managed by the government or the private sector.²⁴ Membership of explicit DIS is generally mandatory for banks, and the payments into the deposit insurance fund come from banks, or jointly from banks and the government. Based on the World Bank DIS database, only four countries appeared to have mandated risk-based bank contributions into the DIS.²⁵ Nevertheless, 2013 IADI Annual Survey Results indicated that more countries were mandating risk-based contributions.

According to Demirgüç-Kunt and Huizinga (2004), various countries with explicit DIS operate with vastly different coverage, funding and management. Higher coverage, coverage of interbank funds, existence of ex-ante funding, government provision of funds and public management reduce market discipline on banks by depositors.²⁶ On the other hand, findings from another study indicates that jurisdictions with explicit DIS but limited coverage are least likely to experience a crisis.²⁷

The effectiveness of DIS in preventing bank failures and systemic crises may be improved by incorporating one or more of the following design features: limiting protection coverage, excluding particular types of deposits, setting coverage limits per depositor rather than per account, improving shareholder and regulatory discipline by private-sector involvement in the management of the DIS.²⁸

22 Demirgüç-Kunt, A. and Huizinga, H. (2004). "Market discipline and deposit insurance", *Journal of Monetary Economics*, Vol. 51, pp. 375–399.

23 Hoggarth, G., Jackson, P. and Nier, E. (2005). "Banking crises and the design of safety nets", op. cit., Vol. 29, pp. 143–159.

24 World Bank (2005). "Deposit insurance around the world: A comprehensive database", *World Bank Policy Research*, Working Paper 3628, (World Bank: Washington, D.C.).

25 Ibid.

26 Demirgüç-Kunt, A. and Huizinga, H. (2004). "Market discipline and deposit insurance", op. cit., Vol. 51, pp. 375–399.

27 Hoggarth, G., Jackson, P. and Nier, E. (2005). "Banking crises and the design of safety nets", op. cit., Vol. 29, pp. 143–159.

28 Following the GFC, a number of these traditional design features were in fact found to be increasing depositors' fears. See Section 2.3 in IFSB WP-06.



In spite of the two opposing views on the effectiveness of DIS, the 2008–9 Global Financial Crisis saw an overwhelming adoption of extraordinary financial safety net arrangements by many jurisdictions to enhance depositors' confidence. The existing DIS in most jurisdictions were substantially enhanced.

During the build-up to the crisis in April 2008, the Financial Stability Board (FSB) released its *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, which stressed the need for authorities to agree on an international set of principles for effective deposit insurance systems (FSB 2008). In response, the Basel Committee on Banking Supervision (BCBS) and the IADI jointly issued in June 2009 Core Principles for Effective Deposit Insurance Systems (Core Principles) for the benefit of countries considering the adoption or the reform of a deposit insurance system (BCBS 2009). After revision in 2014, the Core Principles now stand as a set of 16 principles supported by 96 assessment criteria, against which national DIS can be reviewed.

4.3. Sharī'ah-Compliant Deposit Insurance

The *IFSB IFSI Stability Report 2015* notes that at least 10 jurisdictions and 31 Islamic banks now hold potential relevance for the systemic stability of the global Islamic banking industry, as well as for the overall resilience of the banking sector in the respective country. In other words, Islamic banks in several jurisdictions have achieved domestic systemic importance that warrants a consideration of establishing SCDIS. Hence, the need for Sharī'ah-compliant financial safety nets is profound in the interests of preventing an Islamic bank's failure, which could potentially lead to a systemic crisis.

In a bid to facilitate the means to develop SCDIS and enhance the existing DIS, the IFSB Secretariat conducted a survey of member regulatory and supervisory authorities (RSAs), which was intended to: (a) determine the current status of SCDIS; (b) identify countries' experiences in developing and implementing SCDIS; and (c) ascertain the key issues and challenges faced by central banks/monetary authorities in the development and implementation of SCDIS. The results of the study are summarised according to various themes – namely, current DIS for IIFS, modalities of SCDIS, governance structure and design features, key challenges in operationalisation, and key considerations in SCDIS.



4.4. Results of the Survey

Current DIS for IIFS

The survey results provided useful information on the availability of DIS and of SCDIS, and on the various types of accounts and their protection through SCDIS. The results showed that in 67% of jurisdictions (18 out of 27), a conventional DIS facility exists which is granted universally to both conventional and Islamic commercial banks licensed by a central bank/monetary authority. Meanwhile only four RSAs out of 24 – Bahrain, Malaysia, Nigeria and Sudan – have developed and implemented SCDIS facilities for IIFS in their respective jurisdictions. In addition, a fifth country Jordan has devised an SCDIS framework, but not yet operationalised it yet and as a result the Jordanian SCDIS framework will not be discussed in details. Nevertheless, the remaining 15 RSAs out of 24 that do not have an SCDIS consider it of high importance to develop and implement the scheme in the future.

The RSAs in the four jurisdictions that have SCDIS facilities (Bahrain, Malaysia, Nigeria and Sudan) vary in terms of the types of accounts, the underlying contracts and the extent to which the accounts are protected under the SCDIS. With regards to the types of accounts, all four jurisdictions have investment accounts while only three of them accord protection to the investment accounts through the SCDIS.

Modalities of SCDIS

Results for selected SCDIS modality structures in five jurisdictions – namely, Bahrain, Malaysia, Nigeria, Sudan and Jordan – are covered in the WP. The modality structures in these five jurisdictions vary in terms of the year of establishment, rationale for establishment, categories of IIFS covered, types of accounts protected, the entity covered, underlying contracts, contributors, nature of the scheme and coverage limit.

All the jurisdictions have SCDIS except for Jordan, which is yet to operationalize its modality. In all the jurisdictions, the scheme is pre-funded and covers fully fledged Islamic commercial banks. Almost all types of accounts are protected, with the exception of both unrestricted and restricted investment accounts in Malaysia, and only restricted investment accounts in Bahrain and Jordan. The *takāful* mechanism is used in Bahrain, Sudan and Jordan, while *kafālah bi al-ajr* is adopted by Malaysia and Nigeria. All the selected five SCDIS modalities have varying coverage limits, except in the case of Sudan where the limit is not specified.



Governance Structure and Design Features

In terms of governance structure, the IFSB survey shows that the operational modality of two RSAs (Sudan and Bahrain) is based on the *takāful* structure, while Malaysia and Nigeria operate on a *kafālah bi al-ajr* SCDIS. The governing body structures in the four jurisdictions vary. Sudan's SCDIS has a fully separate board of directors or similar governing body. Bahrain, Malaysia and Nigeria share their SCDIS governing body with a Centralised DIS in their jurisdictions. The members of the board and their appointments also vary across all four jurisdictions. For example, in Bahrain, the 11 members are appointed by the Central Bank Governor; while in Malaysia, two of the board members are ex officio and the remaining seven are appointed by the Minister of Finance. Regarding the Shari'ah compliance arrangements, Sudan indicated that its SCDIS has an internal Shari'ah committee or equivalent. In Malaysia, the Central Bank Shari'ah Board also advises the SCDIS. Bahrain, which previously did not have internal Shari'ah compliance arrangements, indicated that investments made from the Islamic fund must comply with Islamic Shari'ah principles and be under the supervision of the Central Bank's Shari'ah board. However, recently, the CBB has issued Resolution No. (20) for the Year 2015 in Respect of the Establishment of a Centralized Shari'ah Supervisory Board under which there will be an internal Shari'ah review function within the CBB. Part of the internal Shari'ah review function's responsibilities will be the internal Shari'ah compliance review of the SCDIS in Bahrain.

The SCDIS schemes in all four jurisdictions are prefunded, although their investment strategies vary. In Sudan, the strategy is to minimise risk by investing mostly in government securities. In Malaysia, the objective is to preserve capital and maintain liquid assets. Bahrain focuses on Shari'ah compliance and investments should be done only in liquid safe financial instruments while in Nigeria, investment strategy is to invest in liquid and Shari'ah-compliant investments.

With respect to ownership of the accumulated contributions, Nigeria specified that they belong to the banks' clients, while Sudan and Malaysia indicated they belong to the body administering the SCDIS. Bahrain stated that the contributions of the conventional and Islamic banks belong to their respective funds. Meanwhile, Sudan, Malaysia and Nigeria have back-up guarantees from government in place should the fund be insufficient.

Payments to clients of a failed bank are triggered in Nigeria when the bank's licence is revoked. In Sudan the trigger occurs when the central bank decides to liquidate the bank in question. In Malaysia, it is invoked when a winding-up order has been issued by the court in respect of an Islamic member bank. In Bahrain, the trigger is set either when the bank is put under the administration of the central bank or when



it is put into liquidation. In all four jurisdictions, it is the SCDIS that is responsible for determining that the trigger has been activated.

With respect to payments to eligible clients, Sudan and Nigeria have timetables that also prioritise payments. Meanwhile, of the four jurisdictions, the RSAs in Sudan had used SCDIS in the past (in response to an actual banking failure). Similarly, only Malaysia had tested SCDIS in a simulation of a banking failure. Following the simulation, some policies and procedures in relation to the operations of SCDIS had been improved and the roles and responsibilities of relevant divisions within SCDIS enhanced.

Key Challenges in Operationalisation

In the 15 RSAs (out of 24) that did not have a SCDIS but considered it of high importance to develop and implement in the future, five RSAs out of 15 (33%) indicated that they had assessed and studied the necessary legal, tax and regulatory aspects to accommodate the development of SCDIS in their jurisdictions. Two of these five cases had created the necessary legal, tax and regulatory framework, but were yet to put it into operation. None of the RSAs in the sample had assessed the operational procedures and processes under which the SCDIS would function.

Twenty RSAs that do not have SCDIS (including the 15 noted above) were asked to rank a list of six challenges they would face in implementing SCDIS in their jurisdictions. The respondents considered legal issues (such as formulating the necessary changes to existing laws, regulations, etc.), Sharī'ah issues (such as differing interpretations of Sharī'ah rulings, or *fatāwā*, on financial matters across the jurisdiction), and legislative issues (such as securing the necessary approvals from the legislative body, Ministers, etc.) as the most significant challenges. In addition to these six challenges, others identified by some RSAs include lack of guiding principles and differing Sharī'ah views on "deposit" insurance, development of a risk premium assessment methodology, public awareness and understanding of coverage under SCDIS, and the shortage of high-quality (highly rated) Sharī'ah-compliant liquid assets.

Key Considerations in SCDIS

Apart from the Sharī'ah considerations, due emphasis should be placed on the compliance of SCDIS with an international set of principles for effective deposit insurance systems.

Sharī'ah considerations include ownership of *takāful* funds, protection of IAHS by SCDIS and recoveries/subrogation in *takāful*-based SCDIS. There are varying opinions on who will own the *takāful* fund upon the liquidation of the SCDIS scheme.



In Jordan, the fund is not owned by a single entity; hence, upon liquidation, it should be transferred to the national *zakāh*. In another opinion, the ownership of the fund belongs to the participants. Similar to the *takāful* fund, there are controversies regarding the protection of IAHs by the SCDIS. According to the majority of Sharī'ah scholars, a *muḍārib* (entrepreneur) in profit- and loss-sharing contracts may not provide any sort of direct or indirect guarantee to the *rabb al-māl* (capital providers). Doing so will be in violation of the legal maxim "liability accompanies gain". This view is also adopted by the Higher Sharī'ah Supervisory Board (HSSB) of Sudan and the Fatwa Council of Islamic Studies and Research (FCISR) of Jordan, although they permit the establishment of a separate *takāful* fund to which the IAHs themselves can contribute for the purpose of receiving protection for their accounts. Another consideration relates to the issues of recoveries/subrogation in *takāful*-based SCDIS. The concept of *takāful*, which is based on mutual cooperation and providing protection to participants, does not require the beneficiary IIFS to pay back the assistance received if the failure of the IIFS was not caused by the negligence or misconduct of the management. Hence, applying the concept of subrogation in a *takāful*-based SCDIS will create a complication in terms of the ability of the *takāful* fund to recover the losses incurred by paying the depositors of the failed IIFS.

In contrast, in the *kafālah bi al-ajr*-based SCDIS, the deposit insurer provides a guarantee commitment to an IIFS in return for a fee to the deposit insurer. This fee arrangement is disputed by the majority of scholars, although some of them permit it. By the nature of this scheme, the funds belong to the deposit insurer and the SCDIS can pursue the IIFS to recover funds disbursed to depositors if an event triggers the guarantee to come into effect.

Considerations for the compliance of SCDIS with international set of principles would require the adoption of revised Core Principles for Effective Deposit Insurance Systems released by the IADI. These principles address a range of issues, including: public policy objectives, mandate and powers, governance, relationships with other safety-net participants, cross-border issues, a deposit insurer's role in contingency planning and crisis management, membership of the deposit insurance system, coverage, sources and uses of funds, public awareness, legal protection, dealing with parties at fault in a bank failure, early detection and timely intervention, failure resolution, reimbursing depositors and recoveries.

4.5. Conclusion

The development of an SCDIS needs to tally with a coherent strategy for the development of Islamic finance in the various jurisdictions. There will always be a need for Sharī'ah-compliant liquidity, instruments and investments for an SCDIS. These become more challenging as the IIFS integrates with the global financial landscape, especially in a mixed banking environment.



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SHARĪ'AH-COMPLIANT MODELS FOR THE DEPOSIT INSURANCE SYSTEM: AN APPLIED FUNDAMENTAL JURISTIC STUDY

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5.1. Balance is the Solution

If we ponder over this vast universe, the heavens, the earth, the seas, and all living creatures, we will find everything based on a balance accurately established among all the components, and even within each individual component. Balance is the main factor that keeps all natural processes going without irregularities or malfunctions; Allah, the Almighty, says in the Qur'ān: "The Most Gracious (al-Raḥmān), He has taught (you mankind) the Qur'ān.¹ He created man and taught him to articulate.² The sun and the moon follow their calculated courses; the plants and the trees prostrate;³ He has raised up the sky. He has set the balance."⁴ According to the aforementioned verses, everything in the universe is regulated by a strict balance, which is why Almighty Allah has commanded man to manage the world in accordance with this balance: "...so that you may not exceed in the balance: weigh with justice and do not fall short in the balance. He set down the Earth for His Creatures..."⁵

Almighty Allah has commanded humanity, to whom He has made this universe subservient, to maintain balance in all their activities and interaction with the universe and all its parts by avoiding all sorts of transgressions. He commanded us not to exceed the limits and to establish the balance in a fair and just manner and to scrupulously avoid causing any damage or harm to the balance. Almighty Allah has furthermore made it clear that even though He has created everything on Earth to be at the disposal of man, to invest and to make use of in the way that best contributes to the wellbeing of everyone, the Earth was created for all the creatures living on it, including human beings, plants, animals and ecosystems. All living creatures have rights which they are not to be denied.

Additionally, all divine messages have been revealed to maintain the balance between our duties to Allah, our duties toward one another, and even to maintain the balance between the various duties. The whole universe is based on balance, as Allah, the Almighty, states in the Qur'ān: "As for the earth, We have spread it out, set firm mountains on it, and made everything grow therein in due balance."⁶

1 One interpretation is that "Qur'ān" here means "to read". M. A. S. Abdel Haleem (2005). The Qur'ān: A New Translation, (Oxford University Press: Oxford).

2 "*Bayān*" (communication) involves both expressing oneself and understanding what has been expressed by others, including the Qur'ān, which is called "*bayān*" and "*mubīn*" (M. A. S. Abdel Haleem, The Qur'ān: A New Translation).

3 "*Sajada*" means "to submit" and consequently also "to bow down" or "to prostrate oneself" (M. A. S. Abdel Haleem, The Qur'ān: A New Translation).

4 The Qur'ān, Sūrah al-Raḥmān, (55): 1–7 (M. A. S. Abdel Haleem, The Qur'ān: A New Translation).

5 The Qur'ān, Sūrah al-Raḥmān, (55): 8–10 (M. A. S. Abdel Haleem, The Qur'ān: A New Translation).

6 The Qur'ān, Sūrah al-Hijr, (15): 19 (M. A. S. Abdel Haleem, The Qur'ān: A New Translation).



5.1.1 Balance in Islamic Economics and Islamic Banking

In the course of studying the topic of balance in Islamic banking and economics, it can be observed that this balance is one of the most important traits of Islam in general in its legislation and rules, and of Islamic economics in particular. Islamic economics is founded on the balance between private, public and state ownership; the balance between production, consumption, distribution and redistribution; the balance between the role of individuals and the role of the state; the balance between the law of supply and demand; and, finally, the balance between macroeconomics and microeconomics.⁷

Islamic financial products must also maintain this balance, first between the general objectives of the Sharī'ah, and second by balancing risks and rewards. Additionally, Islamic financial products must maintain the balance between private and public interests; between contributing to comprehensive development and to social issues; between generating personal gains and serving the public welfare; between the inclination towards direct investments and guaranteed investments; and between maintaining liquidity and optimising the use of financial resources, etc.

Achieving such balance requires a thorough study of the pros and cons of each product, followed by a period of testing to determine how effective it is in achieving the desired effects and avoiding negative effects on the project itself and on the society.

At this juncture, Islamic financial institutions must subject every product they use to the criteria of *fiqh al-ma'ālāt* (the jurisprudence of consequences), which economists call "economic analysis". It is based on collecting adequate information followed by the process of monitoring and controlling the outcomes of the product or project.

5.2. Sharī'ah-Compliant Structures for the Bank Deposit Insurance System

It is well-known that Islamic fiqh academies have reached a conclusion on the issue of insurance. They have resolved the permissibility of cooperative insurance (*takāful*) and the impermissibility of commercial insurance. One particular resolution deserves particular mention, Resolution No. 9 (9/2) issued by the International Islamic Fiqh Academy (IFA) of the Organization of Islamic Cooperation (OIC) in its second session, held in Jeddah on 10–16 Rabī al-Ākhir, 1406 AH, corresponding to 22–28 December 1985 CE, which states:

7 Al-Qaradaghi, Ali Muhyi al-Din (2012). *Istrātijīyyāt al-Tanmīyah al-Shāmilah*, (Dār al-Bashā'ir al-Islāmiyyah: Beirut). Vol. 1, pp. 179–186.



"The IFA-OIC, after reviewing the presentations submitted by the scholars participating in the session on the topic of insurance and reinsurance; after discussing the presented studies, looking into the various types, structures, principles and objectives of insurance and reinsurance; and after considering the resolutions issued by Islamic fiqh academies and Sharī'ah bodies in this regard, has decided the following:

First, commercial insurance contracts based on fixed installments as used by commercial insurance companies involve excessive uncertainty (gharar), which causes the contracts to become invalid. Therefore, the contract is prohibited (ḥarām) in the Sharī'ah.

Second, the alternative contract that respects the principles of Islamic transactions is the cooperative insurance contract based on the concept of tabarru' (donation) and cooperation. The same applies to the case of reinsurance based on cooperative insurance.

Third, the IFA-OIC calls upon all Islamic countries to establish cooperative insurance and cooperative reinsurance institutions to free Islamic economies from the shackles of exploitation and to guard ourselves against violating the system that Allah, the Almighty, is pleased with for this Ummah. And Allah knows best."⁸

Takāful, or cooperative insurance, is in most cases based on a commitment to pay donations to the pool, or it may be based on the concept of *nahd*, which is our preference;⁹ or it may be based on a gift (*hibah*) with compensation, or on the concept of charitable endowment (*waqf*), as is the case with some institutions. There is no issue regarding the juristic classification of the underlying contract. What is most important is compliance with the relevant Sharī'ah parameters. Therefore, this paper will not deal with any of these aspects.¹⁰ Rather, it will focus on Sharī'ah-compliant structures for the bank deposit insurance system in terms of their permissibility, forms and mechanisms.

5.2.1. The Extent of Permissibility of Bank Deposit Insurance

Bank deposits, according to the customary practice in Islamic banking today, are the funds deposited by clients in any of the following accounts:

8 The International Islamic Fiqh Academy of the Organization of Islamic Cooperation (IFA-OIC), *Majallat Majma' al-Fiqh al-Islāmī*, Issue No. 2, Vol. 2, p. 545.

9 Al-Qaradaghi, Ali Muhyi al-Din (2011). *Al-Ta'mīn al-Takāfulī al-Islāmī*, (Dār al-Bashā'ir al-Islāmiyyah: Beirut).

10 Ibid.



- (a) **Current account:** An interest-free loan whereby customers become the creditors with the right to withdraw the deposit directly, via cheques, or through settlement, and the bank becomes the borrower with the right to make use of the deposit and assumes the consequent liabilities.
- (b) **Savings account:** Managed according to the *muḍārabah* contract wherein the customer becomes the capital provider (*rabb al-māl*) and the bank becomes the entrepreneur (*muḍārib*), and the profit is divided as agreed. The distinguishing features of a savings account are that the customer is allowed to withdraw cash, and the profits generated are usually less than those generated through other investment accounts. A bank may grant its savings account customers some facilities such as an ATM card, telephone banking, free online banking, transfers through an automatic payment order, etc.
- (c) **Short, medium and long-term investment accounts**, which are also based on the *muḍārabah* contract: The bank is the *muḍārib* and the customer is the *rabb al-māl*.

The aforesaid three accounts are permissible by the unanimous agreement of contemporary scholars provided they are structured based on Sharī'ah contracts. The current account is based on an interest-free loan, so it is permissible from an Islamic viewpoint, and the other two types of accounts are based on the *muḍārabah* contract, which is permissible by the unanimous agreement of Sharī'ah scholars. The following discussion relates to insurance of these three types of accounts.

5.3. Insurance for Current Accounts

This type of insurance refers to insurance on debts, which is impermissible when conducted through conventional commercial insurance companies due to *gharar* (uncertainty) and other violations of Sharī'ah principles, as stated earlier in the IFA–OIC resolution. Commercial insurance on debts also involves other issues, in particular when the debt itself becomes the subject matter of the insurance contract; also, the issue of charging fees for the guarantee facility arises.¹¹ Therefore, there is no Sharī'ah authority that has permitted commercial insurance on debts, not even in exceptional cases or in cases of unavailability of Islamic insurance (*takāful*).

Islamic insurance (*takāful*) on debts is permissible in light of the following characterisation.

11 Al-Qaradaghi, Ali Muhyi al-Din, "Insurance of Debts", presented to the First Withāq Conference on *Takāful* Insurance, which was held in Kuwait, 1426 AH; Al-Qaradaghi, Ali Muhyi al-Din, *Al-Ta'mīn al-Takāfulī al-Islamī*, op. cit., Vol. 2, p. 538.



The juristic characterisation (or classification) of Islamic insurance on debts is the same as that of Islamic cooperative insurance. It is based either on *naḥd* (a form of social cooperation), or commitment to pay donations, or offering a gift in exchange for compensation. All these forms fall under the category of donations, in which a certain degree of uncertainty is tolerated.¹²

In addition to this general juristic classification, Islamic cooperative insurance on debts could possibly be classified under the principle of *kafālah* (guarantee) because the guaranteeing party joins his/her liability to the liability of the guaranteed party, undertaking to pay the underlying amount.

However, several criticisms may be raised against this classification; the most significant is that the guaranteeing company does not actually join its liability to the liability of the guaranteed party; rather, it undertakes to pay the debt only in the event of death or permanent disability. That is the case with all the Islamic insurance companies, as far as I know.

Before those trigger events, the insuring company is neither responsible for the debtor, nor a guarantor for him; and in the event of death or total disability the insured party (debtor) is no longer responsible for the debt. Accordingly, the concept of joining liabilities together is not realised; hence, *kafālah* is not realised except in the view of the Ṣāḥirī School, which considers *kafālah* to be a transfer of the debt from the debtor to the guarantor. Even according to the Ṣāḥirī view, the argument is not valid because, in the event that the condition is not satisfied, the insuring company remains free of any liability or responsibility.

From another angle, the *kafālah* contract implies that the creditor has the right to claim the underlying debt from both the guarantor and the guaranteed party, jointly or respectively; however, in conventional insurance on debts the creditor – that is, the financial institution – has no right but to request the payment from the debtor if the agreed conditions are unmet. The creditor can only request the payment from the insuring company in case the agreed conditions are met.

The response to this argument is as follows: this type of *kafālah* is considered a contingent guarantee (*kafālah mu'allaqah*), which is permissible according to the Mālikī School. Even the majority of scholars consider an unconditional guarantee (*kafālah muṭlaqah*) to give the creditor (the financial institution) the right to claim the underlying debt from both the guarantor and the debtor jointly or from one or the other. Abū Laylā, Ibn Shubrumah, Abū Thawr, Abū Sulaymān and the Ṣāḥirī School

12 Al-Qaradaghi, Ali Muhyi al-Din (2011). *Al-Ta'mīn al-Takāfulī al-Islamī*, op. cit., Vol. 1 pp. 236–263, where juristic classifications are discussed and commitment to paying donations or use of *al-naḥd* mechanism is held as the preferable classification.



disagreed with this view. All these scholars view *kafālah* to be like *hawālah*, which necessitates clearing the original debtor of any liability.¹³

Moreover, the concept of a contingent guarantee applies completely to the practice of insurance on debts in the event of the death or permanent disability of the guaranteed party; it is like saying: "If so-and-so becomes bankrupt or dies, I guarantee his debt."

Such a statement has been approved by the Ḥanafī School as long as the guarantee is contingent on a reasonable condition, such as to say: "If so-and-so (the debtor) cannot be found in the town, I will be the guarantor", or any condition which is recognised by the customary practice of that land.¹⁴ This view is also adopted by the Mālikīs and is considered valid in the Shāfi'ī School (although another view is considered more correct). It is also one of two narrations from Imām Aḥmad in the Ḥanbalī School.¹⁵

To conclude, insurance on debts is permissible provided it is arranged by means of Islamic cooperative insurance. This is in line with the resolution issued at the second forum of Dallah Al-Baraka, No. 2/9, indicating permissibility and stating as follows:

"Topic: Insurance against the Risk of Delayed Repayment (16/1)

Question: *Is it permissible for an Islamic bank to obtain insurance for its debts against others in order to hedge itself against the risk of delayed repayment, whether the insurance is obtained via an Islamic insurance company or via an interbank Islamic fund for cooperative insurance?*

Answer: *It is permissible for an Islamic bank to obtain insurance for its debts against others to hedge itself against the risk of delayed repayment via the establishment of a cooperative fund with the participation of all beneficiary Islamic banks, and this is the solution that the Committee unanimously prefers.*

13 For more information, see: Al-Kāsānī, 'Alā' al-Dīn (1986). *Badā'ī' al-Ṣanā'ī' fī Tartīb al-Sharā'ī'*, (Dār al-Kutub al-Ilmiyyah: Beirut). Vol. 7, p. 3423; Ibn al-Humām, Kamāl al-Dīn (No date). *Faṭḥ al-Qadīr*, (Dār al-Fikr: Beirut). Vol. 6, p. 399; Al-Dusūqī, Muḥammad (No date). *Hāshiyat al-Dasūqī 'alā Al-Sharḥ al-Kabīr*, (Dār al-Fikr: Beirut). Vol. 2, p. 265; Ibn Qudāmah, Abū Muḥammad Muwafaq al-Dīn (1347). *Al-Mughnī wa al-Sharḥ al-Kabīr*, (Dār al-Kitāb al-'Arabī: Beirut). Vol. 5, p. 423; Al-Sālūs, Ali Ahmad (1986). *Al-Kafālah fī Ḍaw' al-Sharī'ah al-Islāmiyyah*, (Maktabat al-Falāḥ). pp. 94–97.

14 Ibn 'Abdīn, Muḥammad (1992). *Hāshiyat Ibn 'Ābidīn*, (Dār al-Fikr: Beirut). Vol. 5, p. 295, 305–306; Ibn al-Humām, Kamāl al-Dīn (No date). *Faṭḥ al-Qadīr*, op. cit., Vol. 6, pp. 291–294.

15 Al-Dusūqī, Muḥammad (No date). *Hāshiyat al-Dasūqī 'alā Al-Sharḥ al-Kabīr*, op. cit., Vol. 3, p. 338; Al-Ramlī, Shams al-Dīn (1984). *Nihāyat al-Muḥtāj*, (Dār al-Fikr: Beirut). Vol. 4, p. 441; Al-Muḥallā, Jalāl al-Dīn (1995). *Sharḥ al-Muḥallā ma'a Hāshiyat al-Qalyūbī wa 'Umayrah*, (Dār al-Fikr: Beirut). Vol. 2, p. 330; Ibn Qudāmah, Abū Muḥammad Muwafaq al-Dīn (1347). *Al-Mughnī wa Al-Sharḥ al-Kabīr*, op. cit., Vol. 5, pp. 100-102.



As for insurance obtained via an established Islamic insurance company (takāful), it is also permissible. It is essential that a particular system be set up for both types of insurance and presented to the Committee for approval prior to application.”¹⁶

A similar *fatwā* has been issued by the Sharī'ah supervisory and *fatwā* committees of Islamic insurance companies in Qatar, Jordan¹⁷ and other countries.

5.3.1. The Permissibility of Charging a Fee for a Guarantee

Some have raised an issue regarding classifying insurance on debt as a form of *kafālāh*, arguing that this *kafālāh* would generate benefits and fees for the guarantor, which is not permissible according to the vast majority of scholars. To this effect, the IFA–OIC issued its Resolution No. 12 (12/2) stating:¹⁸

“The answer to this argument: we assert that the issue of the guarantor benefiting from fees and profits is valid in the case of commercial insurance, which seeks profits from the insurance transaction itself, and consequently any surplus goes to the insurer. However, in the case of Islamic insurance, the argument is not valid because the company is acting as an agent on behalf of the takāful fund and is not actually the insurer. Thus, the fees charged by the takāful company are on the basis of wakālah (agency fee), which is permissible in Sharī'ah. The takāful fund does not take anything because it represents both the insurer and the insured, and any surplus is returned back to the takāful participants. Hence, the issue of charging fees for providing Islamic insurance on debt is completely irrelevant.

Based on the aforementioned discussion, takāful can be applied to provide insurance for current accounts for the benefit of the depositor (the account holder). Likewise, the third-party guarantee is also valid based on the kafālāh contract, in addition to the fact that the lending bank (the creditor) is the primary guarantor.”

16 Islamic Juristic Rulings on Insurance, Dallah Al-Baraka, General Secretariat of the Juristic Board, compiled, edited and indexed by Dr. Abdul-Sattar Abū Ghuddah and Dr. Ezz al-Din Mohammad Khoja, p. 193.

17 Rulings of the Sharī'ah Board of Jordan Islamic Insurance Company, issued on 27/8/1421, corresponding to 23/11/2000.

18 The International Islamic Fiqh Academy of Islamic Cooperation (IFA-OIC), *Majallat Majma' al-Fiqh al-Islāmī*, Issue No. 2, Vol. 2, p. 1035.



5.4. Insurance for Savings and Investment Accounts

- (a) It is well known that bank deposits represent a large portion of the national income of countries where Islamic banks operate. As such, any substantial losses in these deposits would impact the status of the nation as a whole. Therefore, efforts to provide as much security and safety as possible for such deposits are eminently justifiable. This is consistent in principle with the objectives of the Shari'ah with regard to the preservation and development of wealth. That is why we find the longest verse in the Qur'an instructing that debts be documented and that wealth be protected through *rahn* (pledge), *kafalah* (guarantee) and other mechanisms. Furthermore, earning profit is one of the objectives of investment. That is the reason that Almighty Allah has commanded those who invest the wealth of orphans to spend on the orphans from the profits generated from the investment, He states: "...make provision for them from it, clothe them, and address them kindly...."¹⁹ Allah enjoins taking the expenses for provisions and clothing out of the profits generated, not from the original capital. Allah, the Exalted, also mentions in the Qur'an: "then when the prayer has ended, disperse in the land and seek out God's bounty. Remember God often so that you may prosper."²⁰ Almighty Allah enjoins seeking profit through work and trade.
- (b) Some people claim that trade and investment in Islam are inherently linked to risk; however, this claim needs further elaboration. This is because commercial contracts in the Shari'ah do not carry the same features. In some contracts, risk is confined to debt repayment. Examples of such contracts are deferred-payment *murabahah* and other deferred-payment sales, salam (forward) sales, and *istisnā'* (the manufacturing contract). In these contracts, the counter-value becomes a debt that must be paid in all cases. As such, the debt is subject to all means of securities to ensure its repayment.

When there is a potential risk of loss or damage before concluding the deal with the customer, such risks are minimal and short-term and can be avoided through Islamic insurance (*takāful*) and reducing the period between the purchase and the sale to the customer.

Another category of Shari'ah contracts comprises usufruct-based contracts such as *ijārah* (lease contract), which involves very little risk, especially with a promise-of-ownership arrangement.

19 The Qur'an, Sūrah al-Nisā', (4):5 (M. A. S. Abdel Haleem, The Qur'an: A New Translation).

20 The Qur'an, Sūrah al-Jumu'ah, (62):10 (M. A. S. Abdel Haleem, The Qur'an: A New Translation).



As for contracts that do involve risks, such as partnerships (*mushārah*), profit sharing (*muḍārah*), and investment agency (*wakālah bi al-istithmār*), such contracts have their particular features, and they contain the same risks present in investments, which can be minimised through several instruments, as will be highlighted in this research.

Khaṭar (risk) means hazard and danger, and all its connotations indicate the possibility of incurring loss and harm that is likely to exceed the possibility of generating profit or benefit. Hence, when the matter is certain it is not called risk.

The possibility of damage and benefit, loss or profit, destruction or salvation is closely associated with the vast majority of human activities. The problem is when the possibility of danger exceeds reasonable limits. Therefore, a reasonable level of risk is acceptable, and the danger lies in what exceeds the limit and falls into hazard and gambling.

High risk is associated with *gharar* (uncertainty), which is prohibited in exchange contracts. Prophet Muḥammad (peace be upon him) forbade *bay' al-gharar* (sale contracts that involve considerable uncertainty).²¹ Risk and *gharar* (uncertainty) are related, overlapping concepts.²² When risk reaches a certain level it becomes a type of gambling, which is prohibited in Islam, based on conclusive texts from the Qur'ān and Sunnah as well as the consensus of Shari'ah scholars.²³ As for minor or tolerable risk, it is permissible in some Shari'ah contracts within the following three parameters:

- (i) Risk has to be accurately measurable and precisely recorded, which means any risk that cannot be analysed or measured is deemed unacceptable from

21 Muslim, Abu al-Ḥasan (No date). *Ṣaḥīḥ Muslim*, (Dār Ihyā' al-Turāth al-'Arabī: Beirut). Vol. 3, p. 1153, *ḥadīth* no. 1513. On the authority of Abū Hurayrah: The Messenger of Allah (peace be upon him) forbade *bay' al-ḥaṣāh* (a type of random sale, prevalent in pre-Islamic times, where the object of sale was determined as the one on which a pebble thrown by a potential buyer randomly fell) and *bay' al-gharar*. Imām Aḥmad in his *Musnad* reports another narration of this *ḥadīth* with an authentic chain of transmitters, on the authority of Ibn 'Abbās: "The Messenger of Allah forbade *bay' al-gharar*". Aḥmad ibn Ḥanbal (1995). *Musnad al-Imām Aḥmad*, (Dār al-Ḥadīth: Cairo). Vol. 3, p. 226, *ḥadīth* no. 2752. Abū Dawūd in his *Sunan* also reports the latter narration. Al-Sajjastānī, Abū Dawūd (2009). *Sunan Abī Dawūd*, (Dār al-Risālah al-'Alamiyyah). Vol. 5, p. 259, *ḥadīth* No. 3376 and Ibn Ḥibbān in his *Ṣaḥīḥ*. Al-Dārmī, Ibn Ḥibbān (1993). *Ṣaḥīḥ Ibn Ḥibbān*, (Mu'assasat al-Risālah: Beirut). Vol. 11, p. 327, *ḥadīth* No. 4951.

22 See, regarding the issue of *gharar*. Al-Ḍarīr, Ṣiddīq (No date). *Al-Gharar*, (Dallat Al-Barakah: Jeddah).

23 See Wikipedia, "Financial Risk"; Al Suwailam, Sami (2007). *Al-Taḥawwuf fī al-Tamwīl al-Islāmī*, (Center for Islamic Economics Research: Jeddah); Al-Najlah, Marwan (No date). "*Qiyās wa Taḥlīl wa Idārat al-Makhāṭir al-Māliyyah*", available at www.kantakji.com; and Bil-'Azūz, bin Ali (2009). "*Istrāṭijiyāt Idārat al-Makhāṭir fī al-Mu'āmalat al-Māliyyah al-Islāmiyyah*", *Majallat al-Bāḥith*, Issue No. 7, p. 280.



an Islamic perspective. Therefore, the Islamic Financial Services Board has issued guiding principles of risk measurement in Islamic banking.²⁴

- (ii) Risk has to be explained with due transparency to those involved in the transaction; Islam forbids deliberately concealing risk since the effect of risk in any contract is no less substantial than that of defects in the commodity that is the subject matter of a contract. This is why it is an obligation to clearly reveal any amount of risk in any transaction. To this effect, Prophet Muḥammad (peace be upon him) said: "Whoever cheats others is not of me."²⁵ Cheating is forbidden by the consensus of Islamic scholars.²⁶ Therefore if a seller, for example, does not reveal the defects involved in the subject matter of the sale contract, he is responsible for the defects, and the buyer has the right to claim compensation from him or terminate the contract. This applies to any party that offers an investment product involving risk. The offer provider has an obligation to explain any amount of risk involved in the transaction; otherwise, he is responsible to guarantee the capital and the actual expenses incurred by the other party in the event of loss or damage.
- (iii) Risk has to be in proportion to profits, as Prophet Muḥammad, peace be upon him, said: "Entitlement to revenues corresponds to liability for losses."²⁷ From this *ḥadīth* and other evidence, the well-known Islamic legal maxim has been derived: "Liability goes with gain."²⁸

This equation is founded on the possibility of generating great profits in various types of partnership contracts – including contractual partnership (*shirkat al-amwāl*), profit-sharing (*muḍārabah*), agricultural partnerships like *musāqāt* and *muzāraʿah*,²⁹ and others – coupled with the possibility of loss in

24 Ibid.

25 Muslim, Abu al-Ḥasan (No date). *Ṣaḥīḥ Muslim* (Dār Ihyā' al-Turāth al-'Arabī: Beirut). Vol. 1, p. 99, *ḥadīth* no. 102; Al-Sajustānī, Abū Dawūd (2009). *Sunan Abī Dawūd*, (Dār al-Risālah al-'Alamiyyah). Vol. 3, p. 272, *ḥadīth* No. 3452; Al-Tirmidhī, Muḥammad bin 'Issā (1998). *Sunan al-Tirmidhī*, (Dār al-Gharb al-Islāmī: Beirut). Vol. 2, p. 597, *ḥadīth* no. 1315.

26 Al-Nawawī, Abū Zakaryā (1392). *Sharḥ Sahih Muslim*, (Dār Ihyā' al-Turāth al-'Arabī: Beirut). Vol. 2, pp. 108-109. The explanation of *ḥadīth* No. 102.

27 Al-Dārmī, Ibn Ḥibbān (1993). *Ṣaḥīḥ Ibn Ḥibbān*, (Mu'assasat al-Risālah: Beirut). Vol. 11, p. 299, *ḥadīth* No. 4928; Al-Tirmidhī, Muḥammad bin 'Issā (1998). *Sunan al-Tirmidhī*, (Dār al-Gharb al-Islāmī: Beirut). Vol. 2, p. 573, *ḥadīth* no. 1286. Al-Sajustānī, Abū Dawūd (2009). *Sunan Abī Dawūd*, op.cit., Vol. 5, p. 368, *ḥadīth* No. 3508. Al-Qazwīnī, Ibn Majah (No date). *Sunan Ibn Majah*, (Dār Ihyā' al-Kutub al-'Arabiyyah). Vol. 2, p. 754, *ḥadīth* No. 2243.

28 Al-Suyūṭī, 'Abdul Raḥmān (1990). *Al-Ashbāh wa al-Nazā'ir*, (Dār al-Kutub al-'Ilmiyyah: Beirut). p. 255.

29 [Translator's note:] *Musāqah* and *muzāraʿah* are two types of sharecropping contracts; the latter is based on an agreement between two parties whereby one allows a portion of his unplanted land to be cultivated by the other party in return for a part of the harvest. The former is similar except in one aspect: the labourer is responsible only for irrigation of an orchard.



some cases. Losses in some deals can be compensated by the ample profits generated in other deals or at other times.

A major problem arises in some Islamic financial institutions when they deal in contracts that involve some risk, such as partnership contracts of various kinds, and the profit in those contracts is determined by benchmarking with the prevailing interest rate, for example, 5%. In case the deal generates ample profits, the Islamic financial institution cannot take more than the stipulated percentage (5%); then, if it suffers a loss in another deal, the institution will not be able to bear the loss.

- (c) The principle that capital cannot be guaranteed in *muḍārabah*, *mushārah*, *wakālah*, etc., except in cases of transgression, negligence, or violation of contractual terms is a fundamental issue in the Islamic economic system, which is founded on fairness and the prohibition of injustice and usury (*ribā*). Therefore, raising the issue of guaranteeing the capital, or the capital plus profit, on the pretext that times have changed is very dangerous. We will address some issues raised regarding capital guarantees in the following points:
 - (i) A guarantee of capital along with a stipulated increase is undoubtedly included under the prohibited *ribā* (usury). The issue of *ribā* is non-negotiable for Muslims because it is definitively prohibited by conclusive texts from the Qurʾān and the Sunnah. The prohibition of *ribā* includes banking interest, as was unanimously agreed by the authoritative international Islamic fiqh academies. On that note, the Qurʾān has condemned those who likened sale to *ribā* (usury): "...they say, 'Trade is just like usury,'..."³⁰ First, the Qurʾān condemned this claim from the aspect of religious belief by saying "...God has allowed trade and forbidden usury..."³¹ It is the obligation of Muslims to submit themselves to this command and declare, "...We hear and obey..."³² Second, *ribā* is unjust and causes an imbalance in commercial transactions because it entitles the usurer to take all the benefits involved in the transaction; his capital is guaranteed plus the fixed interest rate without making any effort or taking any risk. His money thus generates more money without worry or work. In contrast, the borrower alone has to bear all the negative consequences of the transaction; he is responsible to fully guarantee repayment of the debt along with the fixed interest at specific times. Otherwise, the interest will be compounded over time. Consequently, neither the concept of *al-ghunm bi al-ghurm* (no pain, no gain) nor *al-kharāj bi al-ḍamān* (entitlement to revenues

30 The Qurʾān, Sūrah al-Baqarah (2):275 (M. A. S. Abdel Haleem, The Qurʾān: A New Translation).

31 The Qurʾān, Sūrah al-Baqarah (2):275 (M. A. S. Abdel Haleem, The Qurʾān: A New Translation).

32 The Qurʾān, Sūrah An-Nūr (24):51 (M. A. S. Abdel Haleem, The Qurʾān: A New Translation).



corresponds to liability for losses) is applied. Instead, the borrower takes the risks and bears the liabilities while the creditor is assured of gain and revenue. In fact, the loan may not yield any revenues to be paid by the debtor.

Islamic economics is based on the recognition of individual ownership and of partnership, and is based on product activity. Partnership means sharing the returns after the deduction of actual expenses. On the other hand, interest is the cost of lending money, or put another way: a rental fee charged for leasing money for a certain period. It is a cost that is always present with borrowed money. It constitutes a burden on the borrower for a consumption loan and a burden on the borrower and the consumer in case the loan is used for production purposes.

The principles of partnership and profitmaking encourage savings and production in that the amount of profit is linked to the success of the investment project. Thus it is directly connected with production and feasibility studies and the huge efforts spent to make the project a success and to further develop it and a conducive environment for it.³³

The concept of partnership is one of the most effective incentives for promoting thinking and hard work to increase production. Investors are attracted to invest their funds in successful projects because they look at the anticipated returns. Even the conventional economic system confirms that profit generation (or the profit rate) is the main factor that encourages saving for investment. (Empirical evidence from financial markets across the world has proved that successful joint stock companies with profitable shares are able to attract as much individual savings as desired to cover their investment needs).³⁴

In fact, the concept of partnership is closely associated with the theory of marginal efficiency of investment. Projects with high returns attract more savings for investment, which increases their competitiveness and urges more production and profit maximisation for the benefit of all parties. "...Let those who strive, strive for this."³⁵

From another angle, Islamic banks enjoy an added advantage of not taking a fixed interest rate on loans. Conventional banks select their customers primarily on the basis of their financial solvency. This is because the bank's

33 'Abdul-Rahmān, Yusrī, *"Al-Bunūk al-Islāmiyyah, al-Usus wa Āliyyāt al-'Amal wa Darūriyyāt al-Taṭawwur"*, research paper submitted to the Financial Industry Symposium, held in Alexandria on 18–21 Rajab 1421, p. 9.

34 Ibid.

35 The Qur'ān, Sūrah al-Muṭaffifīn (83):26 (M. A. S. Abdel Haleem, *The Qur'ān: A New Translation*).



top priority is to guarantee repayment of its loan plus the interest. The bank does not care much whether the borrower is making high or low profits.³⁶ It does not care whether the loan is for production or consumption purposes. The only thing that matters to conventional banks is securing the loan with sufficient guarantees to ensure its repayment along with the added interest.

In contrast, when an Islamic bank gives financing to its customer on the basis of partnership (*mushārah*) or profit sharing (*muḍārah*), it cares about two things: protection of the capital as much as possible, and selection of successful investors who achieve the highest possible profits, since the bank is a partner in profit sharing. Thus, Islamic banks are the best choice when it comes to optimal use of financial resources.

Similarly, when an Islamic bank invests the capital of its customers on the basis of *muḍārah* or *mushārah* partnership, the bank is not responsible to guarantee the returns or the safety of the capital itself so long as it has not committed any act of transgression or negligence or any breach of contractual terms. This way, the capital does not form a burden to the bank: if profits are realised, the bank takes its share; otherwise, the bank loses nothing but the effort put into the project. However, conventional banks are responsible for both capital and the interest in any circumstance.

On the practical level, economic studies and the World Bank's reports have explained that interest rates and credit management policies applied since the 1960s have had a negative impact on depositors and investors (creditors and debtors). Such policies also have led to misuse of financial resources and bias towards the distribution of credit in favour of major customers and have resulted in a sharp decrease in investment efficiency and a considerable rise in inflation rates.³⁷

Newspapers reported that when Brazil was unable to repay its debts it proposed to creditor countries to enter into *mushārah* or *muḍārah* contracts as a solution to outstanding debts because the mechanism of partnership contracts does not transfer all the responsibilities to the debtor alone (the partner). Hence, Islamic banking opens new channels for the distribution of financial resources among investors so long as they perform their roles according to the established Islamic principles.

- (ii) Capital guarantee leads to the disruption of the concept of partnership. It inflicts injustice upon the managing partner, who may act with the utmost

36 'Abdul-Raḥmān, Yūsī, "Al-Bunūk al-Islāmiyyah, al-Usus wa Āliyyāt al-'Amal wa Ḍarūriyyāt al-Taṭawwur", op. cit., p. 11.

37 World Bank, *World Development Report*, Staff Report No. 410, April 1987, 16:715.



diligence and professionalism, despite which the project may incur losses due to circumstances beyond the manager's control. Why should he be penalised and held liable for such a loss? The prohibition of guaranteeing the capital of investment is considered one of the major principles of Islamic economics. Not guaranteeing the capital in investments is thus one of the most important principles of Islamic economics for investments. No partner (neither a *muḍārib* nor a *sharīk*) can be held liable except in cases of transgression, negligence, or breach of contractual terms.

- (iii) The claim that Islamic banks today are *muḍārib mushtarak* (joint entrepreneurs for multiple parties) and must be liable for the capital by analogy to the same case of *al-aḥīr al-mushtarak* (an independent contractor offering services to the public at large), this argument has been answered earlier in detail.³⁸

5.4.1. Some Practical Alternatives

While it is important to preserve the concept of no capital guarantee, there are some procedures, which, if followed, could help reduce risks and provide a friendly and secure environment. These procedures are summarised as follows:

- (a) Studies, information and adequate guarantees in cases of transgression, negligence, or breach of contractual terms;
- (b) A third-party guarantee, as issued in Resolution No. 30 (4/3) of the International Islamic Fiqh Academy (IFA–OIC), which states:

*"9. It is permissible to stipulate in the prospectus and ṣukūk muqāraḍah documents that a third party, with separate personality and financial abilities, commits to donate a sum of money without any assigned returns for any potential loss in the guaranteed project, provided that the guarantee is totally independent of the muḍārabah contract. That means fulfillment of the undertaking by the guarantor is not a condition for executing the contract and the related terms among the contracting parties. Thus, ṣukūk holders or the muḍārabah entrepreneur shall have no right to claim the invalidity of muḍārabah or to disrespect their agreed commitments under the pretext that the third-party guarantor has not fulfilled the guarantee commitment and/or under the pretext that the third-party guarantee was a pivotal element for consideration in the contract."*³⁹

38 Al-Qaradaghi, Ali Muhyi al-Din "Madā Mas'ūliyyat al-Muḍarib wa al-Sharīk 'an al-Khasārah", research paper submitted to the Islamic Jurisprudence Council of the Muslim World League.

39 The International Islamic Fiqh Academy of Islamic Cooperation (IFA–OIC), *Majallat Majma' al-Fiqh al-Islāmī*, Issue No. 4, Vol. 3, p. 1809.



- (c) Investment agency with the identification of the transacting party and the method of dealing; also, stipulating the right to sell to oneself within a short period of time; this mechanism does not involve a capital guarantee but reduces the period of bearing risk.
- (d) Economic feasibility studies; as pointed out earlier, such studies are not a form of guarantee yet they constitute solid evidence that places a customer who claims loss or lower profit rates than those expected according to the studies in the position of a claimant in litigation. This means the customer is required to provide strong proof for his claim unless there are clear and manifest reasons for loss or for failure to realise the expected profits.
- (e) Hedging against currency volatilities; currencies nowadays have become subject to large fluctuations, especially after the delinking of currencies from the gold standard. Due to this high volatility, constant changes in currency prices have become a conspicuous characteristic of contemporary economies. Therefore, Islamic financial institutions need to use hedging mechanisms, particularly in contracts based on deferred payments. Such hedging is intended to control undesirable fluctuations in prices generally and currency prices specifically.⁴⁰

5.4.2 The Major Problem

The major problem occurs when Islamic banks implement partnership contracts using an interest-based mentality. They do not execute *mushārah* or *muḍārah* contracts in the real sense of partnership which would realise major profits. The result is to undermine the partnership in terms of the consequences of the contract. They depend on LIBOR (plus a markup) in determining profit rates. This means that any profits above the prescribed percentage go solely to the entrepreneur or managing partner as an incentive or the like. Similarly, if the bank acts as managing partner it waives its right to any profits exceeding the prescribed percentage, in favour of the other party – that is, the customer.

As such, the Islamic bank bears the risk associated with the capital except in cases of transgression, negligence, or breach of contractual terms. Actually, this is a good practice; however, this partnership is not followed to its logical conclusion; the Islamic bank does not share profit based on its percentage of capital contribution or according to the mutually agreed ratio. This is where the defect occurs. In Islamic jurisprudence, parties bearing the risks in the partnership business are compensated with the possibility of generating major profits. When the Islamic bank is deprived of this privilege and allowed only a share of profit equal to the prevalent rate in interest-

40 Al-Sā'ātī, 'Abdul-Rahīm, "*Al-Mushtaqqāt al-Māliyyah al-Islāmiyyah*", research paper submitted to Al-Baraka Islamic Economics Symposium, held in Ramadan 1420 AH, p. 11.



based banks, the desired balance cannot be achieved. On the other hand, if the bank were to proceed with the partnership according to the correct Islamic mechanism, large profits in some projects would compensate for losses that may occur in other projects.

The solution to this issue lies in a root solution and an applied solution:

Root Solution: spread awareness among people on the objectives, the meanings and characteristics of Islamic economics so they may know how to apply Islamic finance correctly and make it a way of life.

Applied Solution: while forbidding fixed interest rates (by whatever name they may be called) in *mushārah* and *muḍārah* contracts, there are some solutions that can reduce difficulty in this issue. Convenient alternatives are available to give a sense of comfort to investors with regard to anticipated profits. These alternatives are as follows:

- (a) Conducting accurate and reliable feasibility studies that meet all the required conditions and that analyse all the expected scenarios to determine the anticipated profit rates. These economic feasibility studies submitted by customers can be used as evidence for expecting profits. Hence, if the client claims loss or zero profit, he becomes responsible for providing reasonable evidence for such claims according to standard business practice. This is a useful mechanism that turns the entrepreneur or managing partner into a claimant who is responsible for providing proof and not the other way around where the bank is required to prove the claimant wrong by providing counter-evidence.
- (b) Reliance in *mushārah* or *muḍārah* contracts on the success stories of the successful projects and management with a high possibility of success, and careful selection of competent and trustworthy personnel with the requisite expertise, track record and repeated successes through accurate studies; this will undoubtedly expand the domain of Islamic financial institutions and will help achieve satisfactory profits that can make up for losses or failures, if any.
- (c) Investment agency based on *murābahah* (cost-plus sale contract) with a specified percentage. For example, a bank would give a customer a sum of money to be invested on the basis of *murābahah* with a profit rate of 7.5%. Such a condition is absolutely valid, and the customer has to comply with it. The bank may not proceed with the deal if it does not find a customer to agree with this percentage of profit in *murābahah*.



- (d) *Ijārah* (lease) contract with a promise of ownership at the end of the lease term. In this kind of transaction, profits can be determined with a considerable degree of certainty.

5.4.3 Cases of Insuring Savings and Investment Accounts

Commercial insurance coverage for savings accounts and Islamic investment deposits is prohibited in Sharī'ah, as discussed earlier. However, cooperative Islamic insurance (*takāful*) is permissible in principle and can be applied to savings accounts and investment deposits in Islamic banks in view of the following cases:

- (a) insuring the investment capital except in cases of transgression, negligence, or breach of contractual terms;
- (b) insuring the investment capital in cases of transgression, negligence, or breach of contractual terms;
- (c) insuring the capital in all cases;
- (d) insuring both the capital and the expected profit.

Cooperative Islamic insurance (*takāful*) in the first case (insuring the investment capital except in cases of transgression, negligence, or breach of contractual terms) is permissible because it does not involve any contradiction to the Sharī'ah. Rather, it involves cooperation in righteousness and piety as well as offering a helping hand to those who face difficulties beyond their control. This type of insurance is of real assistance to all parties. Furthermore, it resembles the third-party guarantee permitted in the IFA–OIC Resolution No. 30 (4/3).

As for *takāful* in the second case (insuring the investment capital in cases of transgression, negligence, or breach of contractual terms), it is also permissible. This is because the positive impact of the insurance goes to the capital provider, who has committed no sin or violation, unlike the *muḍārib*, who did commit sin or violation. To this effect, Allah, the Glorified, states in the Qur'ān: "No soul will bear the burden of another."⁴¹ In addition, Islamic insurance actualises cooperation, apportions and distributes risks, and reduces the impact of loss of wealth, all of which are not only permissible but even recommended in the Sharī'ah.

Some argue that such insurance is cooperation in committing sin and minimising its impact on those who have committed it and who deserve no assistance or cooperation because they have committed acts of transgression, negligence, or breach of contractual terms. All of these are violations and destruction of wealth

41 The Qur'ān, Sūrah al-An'ām (6):164 (M. A. S. Abdel Haleem, The Qur'ān: A New Translation).



and are prohibited and sinful. In this regard, the legal maxim states: “Concessions (*rukhaṣ*) cannot be used in cases of transgression.”

The answer to this argument is as follows: the argument is true; however, it applies only to the entrepreneur, agent, or partner that has committed the violation. Thus, if Islamic insurance (*takāful*) benefits go to the benefit of the transgressor (the entrepreneur) only, it would be impermissible. On the contrary, the *takāful* benefits go to the capital owner, who has not committed any of the aforementioned mistakes. The innocent party (the capital provider) should not be denied access to this compensation because of the wrongdoing of the other party (the entrepreneur). The capital provider is actually a victim who needs assistance and cooperation. Accordingly, the insurance is permissible in this, the second case, as well as the third case.

As for the fourth case, (the insurance for the capital and the expected profit) in all cases or in cases of transgression or negligence only, I prefer the view of impermissibility. This is because, if the profit is fixed in advance, it becomes forbidden in the Sharī'ah and contradicts the principles of *mushārah* (the partnership) contract. As a result, the contract would be void. If the entrepreneur/managing partner pays above and beyond the original capital, it falls under the category of *ribā* (usury). On the other hand, if profit is left undecided and unknown, it falls under the category of *gharar* (uncertainty) and ignorance, which is totally unacceptable even in Islamic insurance (*takāful*).

Besides, how is profit determined in the event of loss in a *muḍārah* contract? Even if the profit is determined, it would still remain null and void. Hence, how is it allowed to offer *takāful* coverage for such a contract in particular when it violates the objective of the Sharī'ah, as Imām al-Shāṭibī stated?⁴²

5.5 An Insurance Mechanism for the Three Types of Bank Deposits

Islamic insurance (*takāful*) can cover bank deposits in two ways:

First, Islamic insurance can cover bank deposits through Islamic insurance companies or through *takāful* branches of global insurance companies. I provide some proposals in this regard:

- (a) It may be suggested that all or most Islamic banks (or at least all the Islamic banks in one country) negotiate with Islamic insurance (*takāful*) companies or *takāful* branches to receive the best offer. Since insurance has a cost that is ultimately borne by the consumer, the less the cost, the better for the

42 Al-Shāṭibī, Ibrahim (1997). *Al-Muwāfaqāt*, (Dār Ibn 'Afān). Vol. 2, pp. 288-289.



Islamic banks to gain greater competitiveness in the market and to attract more investors who prefer to invest their deposits with Islamic banks rather than conventional banks. This can only be achieved through constructive cooperation.

- (b) It is necessary to differentiate between three types of deposits in Islamic banks: shareholders' funds, general deposits, and investment deposits for investors willing to bear acceptable risks in return for higher profits.

The first category (shareholders' funds) can be invested in long-term projects, infrastructure, and whatever contributes to comprehensive development in accordance with economic feasibility studies and acceptable economic criteria, taking into account avoidance of unacceptable risks.

Regarding the second category (general deposits), it requires greater caution as it represents a large segment of customers with varying incomes, especially small depositors. This type of deposit can be invested in local *murābaḥah* (cost-plus) sale contracts, *ijārah* (lease) contracts that end with ownership, and *istiṣnā'* (manufacturing contracts) and the like.

With regard to the third category of deposits, it contains a wide range of opportunities for direct or indirect investment via portfolios and various investment funds. However, there is a need for accurate feasibility studies of each and every project and the avoidance of major or unreasonable risks. The bank must still display the utmost transparency and disclosure of the nature of the investment, the related risk and all relevant matters.

Second, Islamic insurance can also cover bank deposits through cooperation of all or most Islamic banks in establishing a special portfolio (or a special fund) to absorb losses, if any, connected with bank deposits in line with prescribed parameters. As such, each bank would participate via an annual contribution equivalent to the prevailing rate in the *takāful* market.

It is allowed to distribute the annual surplus among the participants in accordance with their contribution through any of the following techniques:

- (a) to distribute the annual surplus among all participants in accordance with the contribution paid by each participant and irrespective of any losses;
- (b) to distribute the surplus solely among the participants who did not receive claims;



- (c) to distribute surplus to those without any claim or to those who claimed less than their contribution. The latter should be given the corresponding percentage of the surplus (and this is eminently fair).⁴³

This portfolio or fund should have a system and contracts to structure the repayment of contributions, expenditures and compensation, as well as distribution of the surplus, etc.

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SHARĪ'AH-COMPLIANT STRUCTURES FOR A DEPOSIT INSURANCE SCHEME

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6.1. Introduction

The issue of protecting bank deposits has been a major concern of regulatory and supervisory authorities and international standard-setting organisations for financial institutions. Their interest has focused on several aspects, including determining the responsibilities of central banks for deposits and the extent to which they should contribute to ensuring the availability of a minimum level of liquidity for depositors in the central banks' capacity as lenders of last resort and as the foremost authorities responsible for protecting deposits. In addition, statutory reserve requirements were imposed on banks in order to protect depositors in the event of financial shock. Other international and local prudential standards were formulated to ensure efficient management of depositors' liquidity in order to overcome any financial crisis. However, the increasing intensity of financial crises whose effects were felt beyond the region where they originated made it of paramount importance to put in place additional prudential plans for the insurance of banks' deposits. Thus, the idea developed of establishing institutions to insure banks' deposits. The general unofficial framework of the concept can be traced back to the early 19th century. It later took an official institutionalised form in 1924 in the Republic of Czechoslovakia, which established a scheme for deposit insurance whose aim was to energise the banking sector after the calamities that had befallen the country during World War I. The United States followed suit in 1933, in the wake of the onset of the Great Depression, which had led to the temporary suspension of operations of 9,000 banks and the bankruptcy of 4,000 others in the first four months of the crisis, during which depositors lost nearly USD3.1 billion.¹ As a result, the Federal Deposit Insurance Corporation was established in 1933. Canada adopted the same concept in 1967. Afterwards, the idea of establishing such institutions was adopted extensively in other countries, including Arab countries such as Lebanon and Jordan. In the context of Islamic finance, the idea of establishing Islamic deposit insurance institutions came at a later period, with Sudan becoming the first country to introduce an Islamic deposit insurance system in 1996, followed by Turkey, which in 2001 developed a deposit insurance system that was administered by the participatory banks of Turkey to protect Islamic deposits. However, in 2005 the Islamic system became part of the conventional system. In that same year, Malaysia and Indonesia followed suit by establishing deposit insurance schemes, with the only difference being that in the case of Malaysia the Islamic and conventional deposit insurance systems operate separately from each other, while in Indonesia both Islamic and conventional deposits are protected under the conventional deposit insurance system.²

1 See <https://www.fdic.gov/bank/analytical/firstfifty/chapter1.pdf>.

2 See [www.iadi.org/docs/DP-DI_From_Shariah_Perspective_\(Final\)_Sep2011_to_IADI.pdf](http://www.iadi.org/docs/DP-DI_From_Shariah_Perspective_(Final)_Sep2011_to_IADI.pdf).



6.2. The Nature of Bank Deposits

Bank deposits – or, in other words, investment accounts, especially unrestricted investment accounts – are trust-based deposits in the possession of an investment manager, whether in his capacity as a *muḍārib* or investment agent. The investment manager can be held liable for these accounts only in cases of misconduct, negligence, or breach of contract. In normal cases, an investment manager is just a trustee, not a guarantor. However, a trustee becomes a guarantor in any of the three above-mentioned cases, and such guarantee can be deemed the first way to protect investment deposits.

Transgression means an investment manager does what he should not do, such as using deposits to further personal interests or disregarding the contract terms. (The latter is one example of transgression, which most scholars refer to in combination as “transgression and negligence”).

Negligence is omission of any of the requirements of deposit management in terms of preserving deposits and securing operations by requiring appropriate guarantees as called for by the existing circumstances. AAOIFI Shari’ah Standard No. 45 on capital protection states: “If the investor sets a condition that certain Shari’ah-compliant tools are to be adopted for capital protection, the trustee must comply with the condition; otherwise, he must guarantee the capital.”³

Breach of contract refers to the entrepreneur’s violation of the terms agreed to with the capital provider. For instance, the capital provider may stipulate that the entrepreneur is not to travel with the money, or is not to trade in a particular commodity, or is not to sell on credit. Upon agreement, the entrepreneur must comply with such conditions. Although some Shari’ah scholars deem setting such conditions passable, it is preferable not to apply them in the case of a trustee since this ruling is controversial, and it is always preferable to choose generally acceptable, undisputable rulings.

As to guaranteeing the capital in fiduciary contracts (*‘aqd amānah*), AAOIFI Shari’ah Standard No. 5, paragraph no. 2/2/1, states:

“It is impermissible in contracts based on a trust relationship, as in agency or deposit contracts, to require a fiduciary to provide a guarantor or a pledge of security because such a condition is against the nature of fiduciary contracts; such a condition is applicable only in cases of transgression,

3 The Accounting and Auditing Organization for Islamic Financial Institutions (2010). Shari’ah Standards, (AAOIFI: Bahrain), Standard No. 45, p. 742.



negligence, or breach of contract. This is particularly impermissible in partnership (mushārah) and profit-sharing (muḍārah) contracts, since it is not permitted to require an entrepreneur/managing partner, investment agent, or one of the partners to guarantee the capital or promise a guaranteed profit. It is also impermissible to market such transactions as guaranteed investments.”⁴

AAOIFI Shari’ah Standard No. 45 concerning capital and investment protection, paragraph 3/6, affirms: “In an investment contract, it is absolutely impermissible to obligate the business conductor to guarantee the capital except in cases of transgression, negligence, or breach of the terms of the contract.”⁵

6.3. Procedural Arrangements for an Insurance System for Investment Deposits in Banks

Procedural arrangements for an insurance system for investment deposits in banks can be divided into two categories, as follows:

- (a) partial arrangements; and
- (b) comprehensive arrangements.

6.3.1. Partial Arrangements

Partial arrangements include:

- (a) voluntary guarantees;
- (b) reserves against losses;
- (c) diversification of investment assets;
- (d) sureties; and
- (e) options

4 Ibid., Shari’ah Standard No. 5, p. 56.

5 Ibid., Shari’ah Standard No. 45, p. 740.



Voluntary Guarantees

Investment deposit guarantees may take this form:

"A third party having a public interest, such as the state, or an interest similar to public interest, such as a guardian or parent, may pledge to voluntarily bear the capital loss without the right to seek reimbursement from the investment manager; for example, the government guaranteeing investment projects. For such a guarantee to be legally valid, the third party must have an administrative capacity independent from that of the investment manager, and neither party should have a direct nor indirect ownership stake of one-third or more in the other."⁶

In the latest amendments made to the AAOIFI Shari'ah Standards, such proprietary relationship is permitted up to 50%. Unless it exceeds this percentage, the third party may guarantee the capital loss arising from an act of transgression or negligence on the part of the investment manager. Meanwhile, the guarantor may not derive any benefit from such guarantee and maintains the right to claim the amount he has paid from the investment manager.

Reserves against Losses

Reserves can be maintained to cover capital losses, provided that such reserves are taken from the investors' capital, not from the entrepreneur's profit share. Before the introduction of AAOIFI's Shari'ah Standards, an accounting standard was issued titled "Reserves and Allocations", and such a reserve was named an "Investment Risk Reserve".

Diversification of Investment Assets

This diversification is meant to generate appropriate returns and reduce risks. Examples of such diversifications, in brief, are as follows:

- (a) combining tangible assets, such as real estate, commodities and the like, and monetary assets such as shares, *ṣukūk*, etc.;
- (b) combining the evaluated assets of two different transactions;
- (c) applying cost-plus sales, lease contracts and partnership contracts; and

6 Ibid., Shari'ah Standard No. 45, p. 741.



- (d) applying cost-plus sales along with earnest money (*'arbūn*) contracts where compensation is guaranteed in case the customer fails to execute the contract.

Sureties

Sureties are intended to secure obligations and prevent debt loss or procrastination in repayment. Means of securing obligations include recording debts in writing, witnesses, guarantees, pledges, cheques and promissory notes.⁷ Deposits can be protected by pledges, guarantees, letters of credit, etc., to secure any debts resulting from exchange contracts and to guarantee thereby their recovery.

Options

Options are among the means to protect deposits from arising losses. The most important of these are:

- (a) Cash option: This is a right maintained by a contracting party to terminate the contract due to lack of payment.⁸ For instance, a lessor may terminate the contract if the lessee fails to pay the rent or delays payment or fails to pay one or more instalments on time.⁹
- (b) Stipulated option: This is a right maintained by either or both transacting parties to terminate the contract throughout the option period.¹⁰

6.3.2. Comprehensive Arrangements

Comprehensive arrangements include:

- (a) Islamic cooperative insurance (*takāful*); and
- (b) Risk guarantee institutions and funds;

7 Ibid., Sharī'ah Standard No. 5, p. 56.

8 Authored by a group of scholars (1990). *Al-Mawsū'ah al-Fiqhiyyah al-Kuwaytiyyah*, (Dhāt al-Salāsil: Kuwait). Vol. 20, p. 181.

9 The Accounting and Auditing Organization for Islamic Financial Institutions (2010). op. cit., Sharī'ah Standard No. 34, p. 557.

10 Ibid., Sharī'ah Standard No. 1, p. 14.



Islamic Cooperative Insurance (Takāful)

Takāful (Islamic insurance) is an agreement between individuals exposed to certain risks to mitigate the resulting losses by paying contributions of a charitable nature.¹¹ Such contributions may be on the basis of commitment to donate or *waqf* or cooperative participation, as stated in the latest resolution of the International Fiqh Academy of the Organization of Islamic Cooperation (IFA–OIC) on the topic. An example of a *takāful* arrangement to protect investment deposits is mentioned in AAOIFI Sharī'ah Standard No. 45, paragraphs no. 4/1, 4/2 and 4/3, which state:

"Cooperative insurance can help protect investment deposits through the following Sharī'ah-compliant capital protection methods:

- *Offering takāful for an investment account to protect the capital or cover the risk of transgression, procrastination, death or bankruptcy. Investors may personally carry out the administration of the cooperative insurance contract, or the investment manager may do so in its capacity as their agent;*
- *Offering takāful to cover assets leased in *ṣukūk* and other instruments against damage and basic maintenance risks;*
- *Offering takāful to guarantee exports and investments."*¹²

Risk Guarantee Institutions and their Funds

These funds are based on founding an institution with the necessary administrative capacities. The institution then raises resources through its capital, subscriptions by affiliated institutions, fees, commissions on transactions, and profits generated from the institution's investments. Added to these are grants, endowments and donations collected after acquiring the funds needed as assets, as well as any other resources approved by the institution's board of directors in accordance with the applicable laws.

Contributors/Participants

Contributors are all the participating financial institutions, whether they were involved in the institution's incorporation or joined afterward. Here the problem arises of combining Sharī'ah-compliant and conventional institutions. A separate

11 Ibid., Sharī'ah Standard No. 26, p. 438.

12 Ibid., Sharī'ah Standard No. 45, p. 741.



institution may be established for each, or the unified institution should take into consideration the distinctive character of Islamic banks. This includes applying Sharīah-compliant investment methods and avoiding the mixing of funds of the two types of financial institution. The ideal format would be to invest all the resources collected from all participants in compliance with Islamic Law. That is, irrespective of the source of funds (whether Islamic or conventional institutions), the unified institution should invest all according to Islamic principles and rulings. In case an institution does not adopt a dual system, another problem arises from the participation of all institutions, Islamic and conventional, to cover the losses of any. Islamic banks can cover their losses using the resources contributed by any institution, based on the juristic principle that a change in ownership is treated like a change in the cause of ownership [making the wealth subject to new rulings based on the new status]. With regard to conventional banks, when they need to cover their losses, it must be taken into account that not all their transactions involve violations of Islamic principles – for example, current accounts, agency for investment, and various other banking services. It is also worth noting that the collapse of one bank may trigger a domino economic collapse; therefore, such banks are to be assisted in consideration of public interest.

Deposit Risk Guarantee System

It is compulsory to put in place a system and policies regarding the means of guaranteeing deposit risks in terms of types of risk and fulfilment of the Sharīah conditions and prudential requirements for each type of deposit. It is compulsory that the fundamental system be endorsed by the Sharīah committee and that the resolutions of the Sharīah committee be endorsed, along with precise financial and accounting standards, etc. The balance sheet and financial statements of the Islamic financial institutions should be audited in line with the standards applied in the country.

The question has been raised whether the participation of financial institutions in the capital or the subscriptions [of the guarantee system] contravenes the prohibition of a managing partner bearing financial risks. The solution to this is that the subscriptions are not directed to one depositor or to specific accounts; thus, the subscriptions are not considered a direct guarantee of deposits.

Ensuring Sharīah Compliance of the Institution's Activities

A deposit risk guarantee institution must have a Sharīah board or at least a Sharīah advisor. The board of directors must also include a non-executive director from among the members of the Sharīah board to ensure that all the activities and



operations of the institution are Sharī'ah-compliant, that its investments are sound, and that revenues are purified when necessary. It is preferable to channel the incomes from Sharī'ah non-compliant activities to charity.

The Board of Directors and the Executive Management

As previously stated, the board of directors should include a member from the Sharī'ah board (a non-executive director so as not to create a conflict of interest with the system of the Sharī'ah board). The board of directors is primarily responsible for planning and directing. Among its most important duties are:

- (a) endorsement of the general policy and annual plans of the institution, following the approval of the Sharī'ah board;
- (b) endorsement of the systems adopted by the institution, following the approval of the Sharī'ah board;
- (c) endorsement of the annual budget and financial statements of the institution;
- (d) follow-up and evaluation of the performance of the executive management;
- (e) endorsement and development of the deposit risk guarantee system when necessary and obtaining accreditation of it from the regulatory and supervisory authorities, following the approval of the Sharī'ah board;
- (f) submitting periodical and upon-demand reports to the regulatory and supervisory authorities.

Among the most important duties of executive management are the following:

- (a) proposal of the general policy, annual plans, budgets, and the financial and internal system of the institution;
- (b) submission of final accounts for the financial year to the board of directors;
- (c) reporting periodically to the board of directors about the activities, plan implementations, and financial status of the institution, and providing any other data required by the board of directors to fulfil its responsibilities.



6.4. Models of Deposit Risk Guarantee Systems

Models of the guarantee system for current and investment deposit risks will be briefly discussed in chronological order.

6.4.1. Bank Deposit Security Fund (BDSF) – Sudan

As stated on its official website, the BDSF, headquartered in Khartoum, was founded pursuant to a special act authorised by the National Transitional Council in accordance with the provisions of Decree No. 5 of 1991 and approved by the President of the State on 17 February 1996 in order to achieve the following objectives and goals:

- (a) A compensatory role exemplified in its guarantee of deposits in guaranteed banks, protection of the rights of depositors and compensation for losses upon their occurrence through cooperation and mutual support on the part of monetary authorities, banks and the depositors themselves.
- (b) Establishment and management of cooperative insurance portfolios, which include a cooperative insurance portfolio for guarantee of current deposits and for accounts governed by the same rules. The participants are banks, the government, and the Central Bank of Sudan and cooperative insurance portfolio. For guarantee of investment deposits and for accounts governed by the same rules, the participants are only investment depositors.
- (c) A significant preventive role complementary to the regulatory role of the Central Bank of Sudan, exemplified in seeking to achieve stability and soundness of guaranteed banks and fostering confidence in them by guaranteeing clients' deposits, especially those of small depositors, and by regularly analyzing their financial status. The BDSF management pays special attention to the preventive role to ensure its effectiveness in early discovery of the weaknesses of any bank. This assists in timely execution of corrective measures, in coordination and consultation with the Central Bank of Sudan through a joint coordinating committee that meets periodically.¹³

Based on the preceding points, the deposit guarantee system applied in Sudan is founded on the idea of two *takāful* funds. The participants in the first fund are the banks, which guarantee current accounts and other similar accounts, as well as the government, represented by the Ministry of Finance

13 See www.cbos.gov.sd/node/7145.



and the Central Bank of Sudan. The government is allowed to contribute to this *takāful* fund because it falls under public interest. Participants in this fund pledge to make annual contributions, which are invested in Sharī'ah-compliant instruments by the board of directors of the banking deposit guarantee fund. In accordance with that, holders of current accounts and other similar accounts will be compensated in the event that any participating bank is dissolved or liquidated. Each account holder would be compensated for the amount of their account up to the limit for such accounts. Participants in the second *takāful* fund are the investment account holders along with the government, represented by the Ministry of Finance and the Central Bank of Sudan, as is the case for the first *takāful* fund. The main difference between the two lies in the lack of participation by the banks in the second *takāful* fund. This is consistent with the *fatwā* issued by the Supreme Sharī'ah Supervisory Council, which considers their participation impermissible because it would be a form of capital guarantee by the managing partner (*muḍārib*).

6.4.2. Deposit Protection Scheme – Bahrain

In 1993, the Kingdom of Bahrain founded a deposit protection council that was primarily concerned with the protection of conventional deposits. The system was amended in 2010; the Central Bank of Bahrain (CBB) launched a protection scheme for deposits and unrestricted investment accounts on 13 January 2011, in its Decree No. 34 of 2010, promulgating "Protection of Deposits and Unrestricted Investment Accounts" in accordance with the provisions of Article No. 177 of the Central Bank of Bahrain and Financial Institutions Act No. 64 of 2006. It is worth noting that the CBB presented the general outline of its plan to protect deposits and unrestricted investment accounts, particularly those of small depositors and investors, to the Sharī'ah Supervisory Council of the CBB. After listening to the presentation and seeking clarification on certain points by the CBB, and after the wording of the decree was modified in accord with the Sharī'ah Supervisory Council's suggestions, the Sharī'ah Council approved the scheme as Sharī'ah-compliant in its basic concept and in the regulations put in place to ensure the independence of the fund for the protection of deposits and unrestricted investment accounts. This is in consideration of it being a type of *takāful* in which voluntary contributions are made to specifically cover the risks to which current account holders and investment account holders in retail Islamic banks may be exposed. On this basis, the Sharī'ah Supervisory Council approved the decree promulgating "Protection of Deposits and Unrestricted Investment Accounts".



Regarding the new deposit protection scheme, the CBB declared:

*"The new scheme has overcome the disadvantages of the previous scheme, most importantly in having funds available to the system instead of depending on liabilities which are difficult to collect in a short time without leaving an adverse effect on the banking and financial system. In order to maintain a level playing field and encourage healthy competition between conventional and Islamic banks, the new scheme provides protection for unrestricted investment accounts of Islamic banks as well as deposits of conventional banks. The new scheme requires establishment of two separate funds (a conventional fund and an Islamic fund), each with its own legal entity and budget separate from the Central Bank of Bahrain, but maintained and managed by one board. Funds are accumulated separately in advance, based on regular contributions offered by the member banks. The board will decide on the investment policy for the money of both funds, and the Central Bank of Bahrain will have the responsibility of executing that policy without compensation and without charging any fees, and it is obliged to invest the Islamic fund's money in a Shari'ah-compliant manner and under the supervision of the Shari'ah Supervisory Council. The two funds cover all eligible accounts, which include all types of deposits in conventional and Islamic banks in addition to the unrestricted investment accounts in Islamic banks."*¹⁴

One of the distinguishing characteristics of the deposit insurance system in Bahrain is that it does not require two separate *takāful* funds for current account holders and unrestricted investment account holders, which is the way the system is set up in Sudan. In Bahrain, there is only one *takāful* fund for both types of accounts, and protection of unrestricted investment accounts is not considered as a capital guarantee by the investment manager (*muḍārib*). That is because the protection offered by the Islamic banks' fund for this type of account is not stipulated in the contract signed by the bank with the investment account holder; rather, it is a voluntary undertaking of the Islamic banks through their participation in the Islamic banks' fund.

6.4.3. Deposit Insurance Corporation – Jordan

In the Hashemite Kingdom of Jordan, the law of the Deposit Insurance Corporation was issued by the Central Bank of Jordan in 2000. The law stipulated as follows:

14 See www.cbb.gov.bh/ar/page_1.php?p=Deposit_Protection_Scheme.



"Article 3: The provisions of this Law shall apply to all Jordanian banks and branches of foreign banks operating in the Kingdom, with the exception of:

Branches of Jordanian banks operating outside the Kingdom;

*Islamic banks licensed to operate in the Kingdom, unless any one of them decides to join the Corporation to have its deposits insured."*¹⁵

The law included a number of articles that were not approved by the Sharī'ah boards of Islamic banks in Jordan. Therefore, a suggestion was made to modify the law, and a project was undertaken to draft the modifications needed to make it Sharī'ah-compliant.

One of the suggested modifications was establishment by the Islamic banks of a fund called the Deposit Protection Fund that would work on the principle of mutual support and mutual cooperation, with contributions to it being voluntary and charitable. The Deposit Protection Fund has a financially independent legal identity within the structure of the Deposit Insurance Corporation. It is comprised of two separate funds; the first is a *takāful* fund for current accounts and accounts operating under similar rules as well as the non-invested portion of investment accounts. It is supplied by the annual subscription fees paid by Islamic banks. The second is a *takāful* fund for the invested portion of investment accounts. The annual subscription fees that are paid by Islamic banks acting as agents of the investment account holders go into it. Investment accounts for specific projects are exceptions to the accounts covered by the rules of the modified law of the Deposit Insurance Corporation. It is worth noting that the modifications to the law were in accordance with the *fatwā* issued by the Council for *Fatwa* and Islamic Research and Studies in its eighth session, held on Thursday, 4/11/1413 AH (20 September 2012 CE), which stated that the modified law is based on mutual cooperation and solidarity and that the contributions to the fund in accord with the law are voluntary and charitable in nature. The objective behind it is the protection of people's wealth in Islamic banks from the risks to which that wealth is exposed. The Council supported the law's emphasis on the necessity of obliging Islamic banks to guarantee the accounts that are loans to them. As for unrestricted investment accounts, the Council took the view that the annual subscription fees paid to the Deposit Insurance Corporation should be charged to the account holders since the fees are intended to mitigate their risks.

15 See www.dic.gov.jo/arabic/index.php?option=com_content&task=view&id=8&Itemid=11.



6.4.4. Perbadanan Insurance Deposit Malaysia (PIDM)

PIDM is an independent government institution established in 2005 to provide guarantees for current accounts in the Malaysian banking sector. When it was first established, PIDM was exclusively concerned with insuring the deposits of conventional banks. However, in December 2010 PIDM expanded its scope to include Islamic insurance on bank deposits, and the Takaful & Insurance Benefits Protection System (TIPS) was founded. The law requires Islamic banks to join this institution and pay annual contributions to have their deposits insured in cases of insolvency. These are classified as a guarantee for a fee by the Shariah Advisory Council of Bank Negara Malaysia, which ruled the practice to be permissible.

It is worth mentioning that, as of 1 July 2015, PIDM stopped insuring investment accounts set up on the basis of *muḍārabah*, *mushārah* or investment agency. It now only insures deposits in current accounts and other accounts subject to similar rules.

The objectives of PIDM include the following:

- (a) promotion of public confidence in Malaysia's financial system by protecting insurance policyholders against loss of their benefits;
- (b) reinforcing and complementing the existing regulatory and supervisory framework by providing incentives for sound management of financial system risks;
- (c) minimising costs of the financial system by finding minimum-cost solutions to resolve the problem of insolvent members;
- (d) contributing to the stability of the financial system by dealing expeditiously with insolvent insurer members.¹⁶

¹⁶ See www.pidm.gov.my/For-Public/Takaful-Insurance-Protection/What-Is-Takaful-Insurance-Protection.



6.5. Conclusion

It is clear from the foregoing discussion that legislative and regulatory bodies as well as international standard-setting organisations for Islamic finance have established a set of preventive measures to protect all types of banking deposits. Some of the measures are partial and associated with the investment project itself. Among them are third-party voluntary guarantees, preventive measures against investment risks, and diversification of investment portfolios so that if one asset incurs a loss the others will compensate for it. They also include provision of security measures to protect the investment and the use of options such as an option to annul in case of failure to pay and a stipulated annulment option.

Other arrangements are more comprehensive. They include application of Islamic cooperative insurance (*takāful*) or establishment of institutions specifically for deposit insurance. With regard to applicable models, the paper highlighted a number of models applied in deposit insurance institutions across several jurisdictions such as Bahrain, Sudan, Jordan and Malaysia, as briefly mentioned earlier. The survey of these models reveals that some institutions give considerable attention to Islamic banks by subjecting them to clear rules and regulations, whereas others include Islamic financial institutions half-heartedly. It is also noted that some institutions declare that all types of deposits are covered, including investment deposits, while some others do not include investment deposits. To conclude, the methods used to protect Islamic bank deposits are plentiful and various enough to reassure customers. Still, regulators and supervisory bodies should exert more effort to develop innovative methods to protect deposits.



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CONCLUSION AND WAY FORWARD

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7.1. Background

The Great Depression that commenced in the US in 1930 marked the beginning of a major economic and financial crisis. The collapse of the Bretton Woods System in the early 1970s was followed by even bigger crises. Since then, the continuous rise of financial globalisation has increased volatility in the global economic and financial system. The 1980s, 1990s and, recently, 2008–9 have been associated with a number of banking and financial crises in diverse regions globally. The aftermath of these crises in the form of banking sector failures has led to increased policymakers' interest in studying prospects of establishing financial "safety nets".

The conventional financial system has well-designed financial safety nets in place, particularly those related to crisis prevention strategies, as part of their comprehensive regulatory and supervisory framework to ensure the soundness and stability of the system.

Cognisant of the need for such financial soundness and stability in the Islamic financial industry, the Islamic Financial Service Board (IFSB) has been highlighting the need to develop Shari'ah-compliant financial safety net facilities in its various publications and initiatives since 2005. Two separate studies on the topics of the lender-of-last-resort (LOLR) and the deposit insurance scheme (DIS) were conducted by the IFSB to respond to the stated needs of the Islamic financial industry. Two working papers were later issued by IFSB on these topics.

The topics were covered in an IFSB–ISRA joint Shari'ah roundtable forum, held in Kuala Lumpur on 5 November 2015, in which Shari'ah scholars, legal professionals, academics and supervisors provided their thoughts on various aspects of these safety nets. It was agreed that the papers presented at the roundtable and during the ensuing discourse would be jointly published by IFSB and ISRA in 2016.

The present article basically provides a summary and critically discusses issues raised in the following six papers that are included for the joint publication. The first three papers are on SLOLR and the next three are on SCDIS.

- (1) The Role of Shari'ah-Compliant Lender-of-Last-Resort Facilities as an Emergency Financing Mechanism
- (2) Lender-of-Last-Resort Facilities: Structuring Shari'ah-Compliant Instruments and Mechanisms
- (3) Shari'ah-Compliant Alternatives for the Function of the Lender-of-Last-Resort for Islamic Banks from the Central Banks



- (4) The Role and Mechanisms of Sharī'ah-Compliant Deposit Insurance Schemes
- (5) Sharī'ah-Compliant Models for the Deposit Insurance System: An Applied Fundamental Juristic Study
- (6) Sharī'ah-Compliant Structures for a Deposit Insurance Scheme

The six papers are very distinct in their approaches, contents and issues raised. The two IFSB working papers are empirical studies that have used mixed methods (quantitative and qualitative), raised practical and current issues, and are robust in their analyses. On the other hand, the four Sharī'ah papers are largely descriptive and have used discursive methods that rely on the authors' experiences and opinions. The other distinction is that the IFSB papers have adopted a pragmatic approach based on expediencies and the current setting of the Islamic finance industry, while the Sharī'ah papers are explorative in nature. The contents of the six papers are hereby summarised in four areas – namely, concepts, current status, Sharī'ah perspectives and new proposed Sharī'ah-compliant structures. Issues that arise in each area are duly discussed.

7.2. Session on SLOLR: Summary of Deliberations

The three papers comprise one IFSB working paper (Chapter 1) and two Sharī'ah papers (Chapters 2 and 3). The IFSB paper has relied on the conventional classical concept of LOLR to build the case for SLOLR. In this concept, the central bank, acting as LOLR, prevents temporarily illiquid but solvent banks from failing in times of panic, by freely advancing reserves to any private bank able to offer collateral. The lending is extended at a [high] penalty rate as the best remedy for the worst money market malady and to discourage unnecessary applications from banks. The IFSB paper has also provided the views of critics of the classical doctrine. Critics argue that in a situation of financial crisis it is not easy to tell the difference between an illiquid and an insolvent institution; that lending has frequently taken place at prevailing market rates and not at the penalty rate; that LOLR results in moral hazard; that the open market operation (OMO) is the only policy required to stem a liquidity crisis; and that the central bank should allow insolvent banks to fail to discourage financial institutions from taking greater risks.

On the other hand, the two Sharī'ah papers have used the term "*al-mus'if al-akhīr*" for LOLR. The terms "*al-mus'if*" or "*al-is'āf*" are literally used in situations of emergencies. Hence, in this context it denotes a body to resort to in a situation of emergency. Both Sharī'ah papers, however, have not provided the literal, technical and operational



definitions of the term and how it relates to LOLR. Rather, they simply describe the role of the central bank as "*al-mus'if al-akhīr*" and the structures it adopts in discharging this function. The use of LOLR by the IFSB paper and "*al-mus'if al-akhīr*" by the two Shari'ah papers may be practical in the short term to suit the needs of SLOLR. The terms are standard and most familiar to the market. Nevertheless, in the long run, more studies need to be done to create alternative terms.

The current status of SLOLR is only discussed in the IFSB paper, which, as stated above, is able to obtain the necessary data through a survey conducted on 38 RSAs that include central banks and monetary authorities who are IFSB members. The results of the survey largely represent the views of fully fledged Islamic commercial banks, which account for 85% of the 27 RSAs in the sample obtained. Furthermore, 85% of the RSAs acknowledge that the LOLR facility is commonly available in their banking institutions and the majority of them use OMO and standing facilities as tools for monetary operation. Meanwhile, the RSAs are at different stages of development in terms of SLOLR facility. Thirty-eight per cent of them indicated that SLOLR facilities have not been developed in their respective jurisdictions as they have conventional LOLR facilities to cater for their needs. Some of the assessments show that one-third of the RSAs have adapted the relevant legal, tax and regulatory aspects to accommodate the development of SLOLR. On the other hand, only six out of the 24 RSAs surveyed have a mechanism in place to provide SLOLR facilities exclusively to fully fledged Islamic commercial banks. The six RSAs use underlying Shari'ah-compliant structures such as *muḍārabah*, *mushārah*, *murābahah*, *tawarruq*, *qarḍ* with *rahn*, commodity *murābahah* and short-term *ijārah shukūk*. Meanwhile, the most significant challenge RSAs face in developing an SLOLR facility is the adaptation and/or modification of the existing laws and regulations. The second-ranked challenge is the shortage of eligible Shari'ah-compliant good collaterals and high-quality Shari'ah-compliant liquid assets. Other issues include the challenges of RSAs transacting directly in the markets, and insufficient deposit insurance scheme facilities and Islamic money market instruments.

The third area of discussion by the three papers is the Shari'ah compliance of LOLR. The IFSB paper has addressed the area at the macro and micro levels. At the macro level, LOLR should be deemed permissible from the *maqāṣid al-Shari'ah* (Objectives of Shari'ah) and *al-siyāsah al-shar'iyyah* (Shari'ah-oriented public policy) perspectives. The former emphasises the protection of wealth from risk, harm and damage. Hence, this would require the central bank to provide an LOLR facility to illiquid IIFS that are unable to find any other sources of funds to protect them from collapsing. From the perspective of *al-siyāsah al-shar'iyyah*, it is necessary for the state to rescue troubled banks by delegating the central bank to maintain the stability of the overall financial and monetary system.



At the micro level, issues discussed by the paper relate to interest-bearing loans, collateral and the reference to “penalty rate”. The paper asserts that the structure of SLOLR to be developed must be free from an interest-bearing element as practised in conventional LOLR. Meanwhile, illiquid IIFS can provide Shari’ah-compliant assets as collateral to obtain an SLOLR facility provided the asset has a good rating, is marketable and complies with the condition of *rahn*. A high penalty rate commonly stipulated in the conventional LOLR can be replaced with “high profit rate” in the case of an SLOLR. Such a profit rate, however, must fulfil the Shari’ah conditions of mutual willing consent (*tarāḍī*), must be free from *ghubn fāḥish* (excessive inequality) and must use a suitable underlying contract and benchmark rate.

The Shari’ah papers discussed two issues. First, the fractional reserve system allows commercial banks to create credit in the system. This makes the banking sector vulnerable in the event of a financial crisis. Second, the use of an interest-bearing loan and the conventional repurchase contracts in the existing LOLR facility are not Shari’ah-compliant. The papers also stated that LOLR can become a source of moral hazard. They also analysed the merits and demerits of the *muḍārabah* contract between the central bank and Islamic bank, the use of mutual loans by the lender-of-last-resort, and the use of commodity *murābaḥah* for the LOLR. The *muḍārabah* facility is considered problematic because the capital cannot be guaranteed, which is the requirement for the central bank LOLR facility. The mutual loan facility is contentious because it is tantamount to *ribā*. Meanwhile, the depth of the commodity market limits the commodity *murābaḥah* and its procedure is complex for large amounts.

Following the discussion of the three papers in the third area, some pertinent issues remain outstanding from the IFSB paper and thus require further studies. First, Shari’ah compliance as suggested at the macro level based on *maqāṣid* and *al-siyāsah al-shar’iyyah* is an exception to the general rule as these perspectives are based on *ḍarūrah* (life-threatening) situations, which cannot be generalised. Furthermore, *ḍarūrah* has a limit, as spelled out in *fiqh maxim* (Necessities are to be assessed accurately and given their proper due). Therefore, there is a need to study what could be considered as the duration of *ḍarūrah*, sufficient to rescue an illiquid bank from a crisis. Meanwhile, there is a lack of discussion on the mechanism for implementing the high profit rate in SLOLR as a substitute for the high penalty rate in LOLR. Furthermore, scholars need to investigate how mutual willing consent (*tarāḍī*) can be free from *ghubn fāḥish* (excessive inequality) if the profit rate is determined based on an interest rate benchmark. As for the two Shari’ah papers, the discussion on the issues of a fractional reserve system, interest-bearing loans, repurchase contracts, moral hazards and the existing SOLR structures are not covered in detail and need further research.



In the fourth area, the three papers have proposed Shari'ah-compliant alternative structures for SLOLR. The IFSB paper has discussed the potential Shari'ah-compliant structures for SLOLR that include *qard hasan*, Commodity *murābahah*, *muḍārabah*, *takāful* and *mushārah*. The two Shari'ah papers have proposed the following alternatives: a *fiqh*-adapted form of repurchase agreement, *qard hasan*, establishment of a joint liquidity fund, investment *shukūk*, *wafā'* sale (promise sale) and *muḍārabah* financing. One of the two papers has discussed the *muḍārabah* structure in detail. The paper suggests a profit-sharing scheme between the central bank and Islamic bank on a daily basis. If the *muḍārabah* contract exceeds one day, it becomes debt on the second day. Hence, the *muḍārabah* contract is terminated and a new debt contract is initiated. This is an interesting proposal coming out of the roundtable discussion. Nevertheless, its practical aspects need to be worked out.

7.3. Session on SCDIS: Summary of Deliberations

Similar to the SLOLR papers above, this section also summarises the contents of three papers on SCDIS (one IFSB working paper (Chapter 4) and two Shari'ah papers (Chapters 5 and 6)) and discusses the issues raised. The three papers will also be presented in four areas in the same way as the SLOLR papers.

In the first area, again the IFSB paper delves into the conventional concept, which considers the deposit insurance scheme (DIS) as an essential component of financial safety nets, established to promote financial stability and protect small depositors from losses in the event of a troubled or failing bank. The paper describes the rise in acceptance of DIS following the 2008–9 Global Financial Crisis. The paper relates that, despite the widespread acceptance of DIS, economists hold two opposing views about its effectiveness. The first view asserts that DIS as policy tools can reduce the likelihood of bank runs. In contrast, the second view argues that DIS induces moral hazard incentives that encourage banks to increase the risk of default due to their limited liabilities or the assurance that depositors' funds are guaranteed. Meanwhile, the two Shari'ah papers have provided the literal, technical and operational definitions of SCDIS. They then trace its historical use from when it was first established in Sudan in 1996 to the present time.

The IFSB paper discusses the current status of SCDIS based on the results of the survey it conducted. The results show that 67% of the RSAs have, in their respective jurisdictions, a conventional DIS facility that is granted to both conventional and Islamic commercial banks. Meanwhile, only four RSAs out of 24 – namely, Bahrain, Malaysia, Nigeria and Sudan – have developed and implemented special SCDIS facilities for IIFS. The paper presented selected SCDIS modality structures in five jurisdictions – namely, Bahrain, Malaysia, Nigeria, Sudan and Jordan. These



modalities vary in terms of the year of establishment, rationale for establishment, categories of IIFS covered, types of accounts protected, the entity covered, underlying contracts, contributors, nature of the scheme and coverage limit. For example, almost all types of accounts are protected except for restricted and unrestricted investment accounts in Malaysia, and restricted investment accounts in Bahrain and Jordan. In terms of governance, for example, with respect to payments to eligible clients, Sudan and Nigeria have timetables that also prioritise payments. The RSA in Sudan had used SCDIS in the past (in response to an actual banking failure), while only Malaysia had tested SCDIS in a simulation of a banking failure. With regards to key challenges in the operationalisation of SCDIS, the most significant are legal issues (such as formulating the necessary changes to existing laws, regulations, etc.), Shari'ah issues (such as differing interpretations of Shari'ah rulings, or *fatāwā*, on financial matters across the jurisdiction), and legislative issues (such as securing the necessary approvals from the legislative body).

Unlike the survey results on SLOLR, the findings on SCDIS raise few issues. This is because SCDIS is relatively well established in its operation. The outstanding issue would be how the modality structures in the various jurisdictions in the Islamic finance industry can be standardised. Hence, further research is required on the modality standardisation and on how to overcome the legal, Shari'ah and legislative challenges mentioned above.

In the third area, the three papers raise few pertinent Shari'ah-compliant issues that remain unresolved. The IFSB paper raises the issue of variations in Shari'ah considerations such as who owns *takāful* funds, and to what extent investment account holders can be protected by SCDIS and how recoveries/subrogation in *takāful*-based SCDIS are triggered. The paper has not suggested, however, how these variations can be narrowed. One of the two Shari'ah papers also emphasises the need for cooperative *takāful* as a deposit insurance facility. The paper argues that the permissibility of deposit insurance on the capital of the investor (depositor) would vary according to four situations. Deposit insurance is permissible in the first three situations – namely: (1) Using cooperative *takāful* to protect the capital of the investor (depositor) where negligence, misconduct or violation of the terms of the contract did not occur; (2) Using cooperative *takāful* to protect the capital of the investor where negligence, misconduct or violation of the terms of the contract did occur. Such insurance is permissible because its positive effect will benefit the capital provider; and (3) Using cooperative *takāful* in all other situations on the investor's capital, which is also permissible because the benefits of *takāful* will be reaped by the capital provider as well. In the fourth situation, it is not permissible to insure the investor's capital together with the profit, under all of the previously mentioned situations or in cases of negligence and misconduct only. This is because agreeing on such an arrangement will be a form of a predetermined condition as the profit is yet to be earned. Thus, it is tantamount to *ribā*.



In the fourth area, largely the two Sharī'ah papers make the proposals for alternative structures for SCDIS. One of the papers has suggested how three types of accounts – namely, current account, savings account and investment account – can be insured. For example, the current account can be insured through cooperative *takāful* on the basis of *al-naḥd* and the commitment to donate or *al-ḥibah bi al-thawāb* (granting a gift with return). The paper also discusses attainable alternatives that could be used to mitigate risks. These include third-party guarantee, the use of investment *wakālah*, economic feasibility studies and hedging against price fluctuations. Other mechanisms suggested include Islamic banks collectively bargaining for the best offer with *takāful* companies or establishing a joint fund. It is worth noting that some of these suggested alternatives – such as third-party guarantee, hedging, *muḍārabah*, *wakālah* and economic feasibility studies – are already operational in the market. Nevertheless, the idea of cooperative *takāful*, banks' collective bargaining and banks establishing a joint fund are promising structures that need further research and deliberations by the relevant stakeholders.

7.4. Way Forward

The Roundtable took note that strengthening the SLOLR and SCDIS safety nets will also support the IIFS in meeting challenging market conditions, especially bank runs and liquidity shortages. The Forum has generated many pertinent new ideas and deliberated on numerous issues and challenges related to SLOLR and SCDIS. It has also highlighted possible solutions to these issues and challenges. Nonetheless, more research efforts are needed to provide theoretical, practical and technical guidance regarding these solutions. Hence, the following recommendations may help enhance the quality of future deliberations and research on SLOLR and SCDIS, which are relevant for the stability of financial systems:

- (a) There is a need to develop operational definitions of SLOLR and SCDIS that could help in developing the framework, principles and structures of the two concepts based on Islamic philosophy and Sharī'ah.
- (b) There is a need to enhance the methodology used in Sharī'ah research. This will allow the research problem to be well defined, the literature to be critically reviewed to identify research gaps, and data to be properly and scientifically obtained and analysed.
- (c) There is also a need for further research on the third element of the financial safety net, insolvency regimes, resolution and recovery of Islamic banks and other financial institutions. In fact, the IFSB has commenced new research on the third element of financial safety nets in 2016.



