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Mudaraba term deposits in Islamic banking – the crucial aspects

Introduction

Significance of Islamic banking has been increasing in the last few decades. Since the 1970s, assets of Islamic banks have been growing dynamically and in 2015 reached US$ 1.5 trillion (Islamic Financial Services Board 2016). A distinctive feature of Islamic banks is the obligation to conduct operations in accordance with the principles of sharia, which is the religious law of Muslims. The basic sharia principle applied by Islamic financial institutions is the prohibition of usury (arab. *riba*), which is understood as any sort of increase over the principal amount. The prohibition of *riba* has huge implications on operations conducted by Islamic financial institutions since none of them can be based on interest. The majority of research papers dedicated to the operations of Islamic banks, concentrate on the asset side of their balance sheet. In this paper, deposits, which constitute a significant part of liabilities, will be analysed. It should be noted that Islamic scholars are generally of the opinion that saving is desirable, or even necessary for the economic and social development of Muslim societies. However, mobilisation of savings in the Islamic banking system is much more challenging than in the conventional one. Deposits cannot be based on interest rate since it is against sharia, but they still should bring certain profits so as to promote savings. Usually, term deposits offered by Islamic banks are based on three different constructions: *mudaraba*, *wakala* or commodity *murabaha*. According to Islamic scholars, *mudaraba* deposits are especially desirable from the point of view of sharia.

The main purpose of this paper is to present the construction of term deposits, based on a *mudaraba* mechanism, the problems associated with this type of deposits and to investigate how Islamic banks deal with them. The analysis conducted in the article is based mainly on scientific literature and regulations.

1. Principles of Islamic banking

The purpose of the Islamic financial system is just like in the case of the conventional one, to facilitate a smooth flow of funds between savers and investors. However, what is distinguishable about the Islamic financial system is that it is based on the principles of sharia – Islamic religious law. Sharia regulates all spheres of life, including politics and economy. Compliance with sharia principles should ensure that the Islamic banks act ethically and do not exploit in any way their partners, whether these are their individual or corporate clients or other financial institutions.

The main principles of sharia, which have a big impact on operations of Islamic banks, include: prohibition of interest (*riba*), avoidance of uncertainty (*gharar*), prohibition of trading in illegal (*haram*) products, reliance on the participation model of banking.

The basic principle applied by Islamic financial institutions is the prohibition of interest (*riba*). It also constitutes the main difference between Islamic banks and conventional financial institutions, which base all their operations on interest rate. The prohibition of *riba* has its origins in the holy book of the Muslims – the Koran. The hadiths, which describe the life and actions of Muhammad, the Messenger of Allah, also state that *riba* is condemned. However, neither the Koran nor the hadiths define what *riba* is. According to most Islamic economists, it is any sort of increase over the principal amount (Hasanuz Zaman 2001). According to Islamic scholars, *riba* creates wealth without being the outcome of productive economic activity and all interest-based financial arrangements are unfair and morally unjustifiable. The prohibition of *riba* means that Islamic banks must construct all their instruments, whether on asset or liabilities side of the balance sheet, in such a way that they are *riba* free.

The necessity of avoiding *gharar* is another principle that must be followed by Islamic financial institutions. Islamic scholars define *gharar* as ignorance (*jahl*) or the lack of knowledge about the physical attributes of the subject transaction and the lack of knowledge that the object exists. *Gharar* can be also understood as an inequality in the bargaining power that arises from ignorance or the lack of knowledge about the subject matter and features of the contract (Balala 2011). Mainly due to that principle, derivatives are hardly used in Islamic finance (Sobol 2012).

Islamic banks are also not allowed to invest in activities which are considered *haram* (illegal). Thus, they are not supposed to provide finance to companies or individuals involved in industries as those related to alcoholic beverages, pork products or pornography.

Another important Islamic banking principle, which results from the prohibition of *riba*, is the necessity to base the bank's operations on a participation model, meaning that participants of a financial transaction should share profits and losses

of this transaction. A financial transaction which transfers all the risks associated with an investment project to a single stakeholder is, therefore, contrary to the principles of Islamic banking. The basic principle of a participation or profit and loss (PLS) model is that instead of lending money at interest, the bank forms a partnership with the borrower, sharing in a venture's profits and losses. Hence, unlike interest-based products, in the case of PLS instruments, there is no guaranteed rate of return on the investment, since income depends on the profit earned by the partnership company and may possibly result in losses.

2. Construction and types of term deposits based on *mudaraba*

Most Islamic scholars regard deposits based on PLS concept as the most desirable from the point of view of sharia. In practice, a *mudaraba* mechanism is usually used as the base for Islamic term deposits.

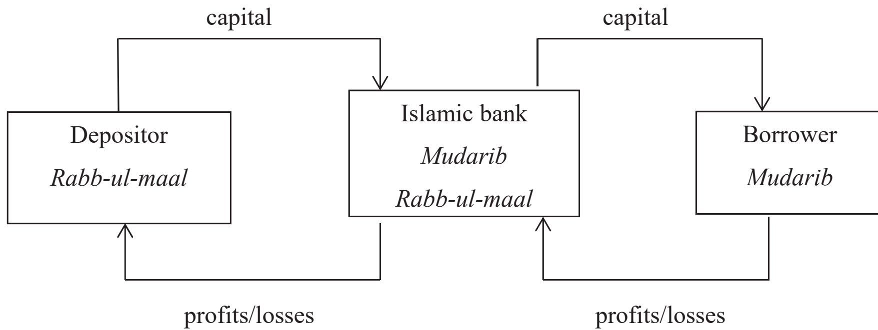
In a *mudaraba* contract, one party of the agreement, called *rabb-ul-maal* provides capital finance for a specific venture indicated by the other party, called *mudarib*. The *mudarib's* contribution to the venture is professional and technical expertise. He is also responsible for the management of the business. If the venture brings profits, they are shared according to a pre-agreed ratio between *rabb-ul-maal* and *mudarib*. Losses, however, are entirely incurred by the *rabb-ul-maal*, with the exception of cases when such losses are the outcome of managerial negligence or the misconduct of the *rabb-ul-maal*. Due to the fact that one of the partners runs the business and the other provides solely finance, the relationship between the partners is based on trust, with the investor having to rely heavily on the entrepreneur, his ability to manage the business and his honesty when it comes to profit share payments (Schoon 2010).

In the past, a *mudaraba* contract was always based on the partnership of two parties. However in modern times, a new model of *mudaraba* – two-tier *mudaraba* – was introduced and adapted by Islamic financial institutions. The model is based on the theory developed by renown Islamic scholar Uzair (1978). In the case of two-tier *mudaraba*, two *mudaraba* transactions are used in one scheme and three parties are included in the contract: the depositors as financiers, the bank as an intermediary and the entrepreneur who needs capital. The first *mudaraba* is conducted between depositors (*rabb-ul-maal*) and a bank (*mudarib*) while the second one between a bank (*rabb-ul-maal*) and a borrower (*mudarib*) (Figure 1). Parties of the first *mudaraba* share the bank's profit while those of the second *mudaraba* share the profit of the borrower (Nagaoka 2012).

Thus, in the case of deposits based on *mudaraba*, depositors (*rabb-ul-maals*) provide the capital to the bank and the task of the bank is to find an investment which will bring profit both to the bank and the depositors. If the investment

brings profits, they are shared according to a pre-agreed ratio between the bank and the depositors. This ratio is determined by such factors as the size of the amount to be invested and the duration of the investment. In some countries, supervisory authorities issue guidelines with regard to this ratio. For example, in Turkey, the investor's minimum profit share is 75 per cent, while the Islamic bank's maximum profit share is 25 per cent (Song, Oosthuizen 2014). In Malaysia, on the other hand, according to the policy document issued by the central bank, this ratio should be within 50–75 per cent, depending on the term of investment (Bank Negara Malaysia 2014).

Figure 1
Mechanism of two-tier *mudaraba*



Source: Author's own.

Two main types of deposits based on *mudaraba* can be distinguished: *mudaraba* special/restricted investment accounts and *mudaraba* general/unrestricted investment accounts. In the first case, depositors restrict the range of assets which the bank can invest their money in. The restriction can also regard the type of transaction (e.g. only leasing) or industry (e.g. no telecommunication). The type of the restricted account depends on the client's investment profile, which includes liquidity requirements, time horizon and propensity to risk (Schoon 2010). It should be noted that restricted accounts are reported off-balance sheet and they fully absorb losses in case of poor performance of their underlying assets. The bank is remunerated for its asset management services and does not take risks related to the underlying assets of those accounts (Damak, Mensah 2016).

Mudaraba general/unrestricted investment accounts are more common and they are usually regarded as the equivalent of conventional deposits. Under the *mudaraba* investment unrestricted account, depositors let the bank decide about the period as well as the type of the investment (Chinoy 1995). It should be also noted that assets in which the bank invests the depositor's funds may be comingled with assets held on behalf of other account holders or the bank's own assets, as a result making them difficult to attribute to specific depositors.

However, the bank should be able to determine the relative shares of all account holders, as well as the bank's shares that financed a particular asset (Awadzi, Chartouni, Tamez 2015).

3. Problems associated with *mudaraba* deposits and some solutions

In the conventional banking system, depositors usually know in advance, what profit a particular deposit will bring. Typically, there is no relationship between non-payment of the loans the bank granted and the deposits. If a loan is not paid, the losses are incurred by the bank or its owners. Only when these losses are so large that they lead the bank to bankruptcy, the assets of depositors are threatened. But in practice, even then, they recover their money because of the various types of deposit guarantee schemes.

As it was already mentioned, in Islamic banking, according to the theory of profit and loss sharing, it is not certain that the depositors will gain profits. Moreover, they can incur losses. And it should be noted that the judgement of managers of Islamic banks is no better than that of their conventional counterparts. For example, Kuwait Finance House lost millions of dollars during the Souk Al-Manakh stock market bubble in 1982 while investing the savings of thousands of Pakistani labourers, in land and Gulf companies' stocks. The depositors had little knowledge of finance, but had a trust in the Islamic institution and invested their money in good faith. But had the Kuwait government not reacted and reimbursed depositors, the labourers would have lost their life savings, even though they banked with an Islamic bank (Seznec 1999).

There can be several approaches to the above-mentioned problem in Islamic banking. First of all, the principle of profit and loss sharing, applied in term investments, can be taken literally and indeed, the depositors can be exposed to the risk of losing the money, deposited in a bank. Islamic banking in the United Kingdom can be an example of such an approach. When Islamic Bank of Britain (IBB), the first British fully-fledged Islamic retail bank (which started operations in 2004), applied for the banking licence in the UK, one of the issues that arose concern was the safety of deposits, based on a *mudaraba* mechanism. Under the British law, customers have the right to a guaranteed refund of the deposit. Representatives of the Financial Services Authority (FSA), which supervised the financial market in the UK at the time, and IBB came to an agreement according to which IBB customers had the right to waive the right to deposit protection on religious grounds and choose instead to be repaid under the risk sharing and loss bearing formula (Ainley et al. 2007).

The fact that the depositors have no guaranteed profit and can even lose their money, can be a big problem, not only for the Islamic banks' clients, but

also for the banks themselves, and for the whole banking system. It should be remembered that usually (with the exception of Sudan and Iran) Islamic banks operate together with conventional banks in the dual banking system. If the rate of return in Islamic banks is lower in comparison with the rate of return in conventional institutions, Islamic banks that offer profit and loss investment accounts are exposed to a displaced commercial risk – DCR (Hamza 2016). DCR is a risk that depositors may withdraw their funds from an Islamic bank and place them with other financial institutions, which offer a higher and guaranteed rate of return. As a result, Islamic banks feel pressured to pay the depositors a higher rate of return than the actual rate of return resulting from the investment. It should be stressed that withdrawals can be a problem not only for a bank, but also for the whole banking system and can also affect the country's economy as a whole.

The solution applied by the Islamic banks are income smoothing techniques. Income smoothing has been a known procedure in conventional financial and non-financial companies for many years and can be understood as an attempt to reduce abnormal variations in earnings of a company under sound accounting and management principles (Beidleman 1973). In Islamic banking, in principle, smoothing may apply to both restricted and general *mudaraba* accounts, but in practice, it is more generally found in connection with the latter, since they are considered an Islamic substitute for conventional deposits.

The importance of income smoothing is recognised by the Islamic Financial Services Board (IFSB), which is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services. In 2010, IFSB issued a guidance note concerning smoothing techniques, that can be used by Islamic banks. Moreover, it should be indicated that in some of the countries (e.g. Jordan and Qatar), avoidance of passing losses onto the accounts holders and application of smoothing is a requirement of the supervisors. And in some other countries (e.g. Bahrain), although there is no such a requirement, smoothing techniques are used by Islamic banks (Archer, Karim 2009).

According to IFSB guidance note (2010), four methods of smoothing are used by Islamic banks:
- forgoing part or all of the *mudarib's* profit share,
- making transfer from shareholders' current or retained profits to investment account holders as a *hibah*,
- using profit equalisation reserve (PER),
- using investment risk reserve (IRR).

In the first case, the share of the *mudarib's* profit established in the contract is usually very high in order to lower it if the profits of the depositors are not sufficient in a particular year. The decision about the lowering of the *mudarib's* profit to give depositors competitive returns, is made by the management of the bank at the end of a financial period.

In the second method, transfers of profit are made from current or retained profits of shareholders on the basis of *hibah*, which can be translated as a gift. So it means that the risk attached to the returns of portfolio of assets financed is borne disproportionally by the shareholders.

Another smoothing method, applied by Islamic banks involves establishing profit equalisation reserve (PER). PER is an amount appropriated by an Islamic bank out of the *mudaraba* income, before allocating the *mudarib's* share for the purpose of ensuring the payment of the market rate of return to the account holders and increasing the owners' equity. On the other hand, investment risk reserve (IRR) is an amount appropriated by an Islamic bank from the investment profits attributable for depositors, after deduction of the *mudarib's* share of profits. While the main role of PER is to stabilise the profit over different financial periods, the role of IRR is used as a cushion against future losses that accounts holders may incur. In the case of PER, both depositors and shareholders of the bank benefit from this tool, while in the case of IRR it is the depositors who are the main beneficiaries. According to the survey, conducted by the International Monetary Fund in 2011 of 39 countries where Islamic banks operate, PERs are allowed in the following countries: Bahrain, Jordan, Kazakhstan, Kuwait, Lebanon, Malaysia, Pakistan, Qatar, Sudan, Syria and Yemen. On the other hand, IRRs are allowed in Bahrain, Kazakhstan, Lebanon, Palestine, Qatar, Syria and Yemen (Song, Oosthuizen 2014).

While all of the methods mentioned above are used by Islamic banks, it is difficult to estimate how common they are. Banks generally do not disclose information about the first two methods and only some of them share information about PERs and IRRs in their annual reports. It also must be pointed out that there are controversies and dilemmas with the application of smoothing techniques by Islamic banks.

One of the problems arising from those practices is the lack of transparency regarding the underlying profit performance of the investments of the *mudaraba* funds. The lack of transparency makes it very difficult for the account holders to monitor the performance of their money and move the money to another account, and this has a negative impact on the market discipline (Archer, Karim 2009). As a matter of fact, the depositors knowing that smoothing is used, may be even discouraged from the monitoring of the bank.

The risk of potential abuse from shareholders against investment depositors is another problem that can arise, since the depositors cannot make decisions about smoothing and usually have no knowledge of it (Åström 2012).

Finally, probably the biggest controversy with the usage of smoothing is the fact that it contradicts the purpose of *mudaraba*, where partners are supposed to share not only profits, but also losses. Having a cushion that can be used in case of loss or low profits, removes some of the risks that the account holders are supposed to have. As a result, the return of the investment deposit does not reflect

the PLS principle, but is benchmarked against the interest rate of a conventional bank, which in turn evokes criticism that Islamic banking is conventional banking in disguise.

This problem is noticed by the regulators of some countries, for example Malaysia. In the Islamic Financial Services Act of 2013, investment accounts are differentiated from deposits with a stipulation that investment accounts can bring losses. Additionally in 2014, the country's central bank, Bank Negara Malaysia (BNM) issued a policy document, where the regulatory requirements on the conduct of investment accounts were outlined (Bank Negara Malaysia 2014). According to this document, smoothing practices are not allowed. At the same time, BNM indicated the requirements that have to be met by an Islamic financial institution, which would safeguard the interest of accounts holders and other stakeholders, as well as ensure stability of the Islamic financial system without breaking sharia principles. How it will affect the Islamic banking industry in the long run and whether other countries will follow Malaysia's example, is still unclear and needs further research.

Conclusions

Islamic banks have been developing very well for a few last decades. In some of Muslim countries, they have become a viable alternative to the conventional institutions. However, they face a lot of challenges, which need to be overcome if they want to be competitive against conventional banks and at the same time want to stay sharia-compliant. One of the problems Islamic banks face, concerns term deposits based on the principle of profit and loss sharing. According to the theory, holders of those accounts may incur losses if a venture which they finance through the intermediary of the bank fails. It can be a factor, discouraging them from placing their savings into such accounts. As a result, banks try to manage those accounts in such a way as to avoid passing losses onto the holders and to smooth the periodic returns paid to them, which however also has some repercussions, not always positive. Some of them, such as non-compliance with sharia, were highlighted in this paper.

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Mudaraba Term Deposits in Islamic Banking – the Crucial Aspects

Summary

Significance of Islamic banking has been increasing in the last few decades. A distinctive feature of Islamic banks is the obligation to conduct operations in accordance with the principles of sharia, which is the religious law of Muslims. The prohibition of interest (*riba*) is considered to be the most fundamental sharia principle that Islamic banks must follow. As a result, transactions conducted by Islamic banks cannot be based on interest. This principle applies also to deposits which, preferably, should be based on the principle of profit and loss sharing. However, banks which offer this kind of deposits, face a number of problems. To overcome them is one of the challenges for the Islamic banking industry.

Keywords: Islamic banking, term deposits, profit and loss sharing, *mudaraba*