Negative Interest Rate and Mudarabah Investment Deposits Rate: A Short Essay

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Abstract

Negative interest rate is quite a new phenomenon and many economists are quite puzzled by this new development after the global financial crisis of 2008/2009 and warned about its negative consequences. Whether negative interest rate can be considered as a Riba, literally interest rate, in Islamic finance is not settled yet. According to the classical text, the logic behind prohibition of interest rate, Riba, is actually inherent injustice; it may be to borrower or lender. There is no ruling or fatwa regarding negative interest rate. However, by following the analogy of injustice in *Riba*, we can argue that negative interest rate should be equated wtih *Riba*. One of the most controversial issues in current Islamic banking practice is that the return on *Mudarabah* investment deposits and interest rate on savings accounts are quite identical if not the same. Three key reasons for this paradox are briefly explained and number of measures has been recommended which might help delinking interest rate from profit rate.

Key words: negative interest rate, Riba, Islamic finance, *mudarabah* investment deposits

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Negative interest rate

Negative interest rate is an atypical situation when a bank charges its depositors for depositing their money in the bank, this is the liability side of the bank, on the asset side of the bank, the bank lend to debtors and consequently debtors payback less than what s/he was originally given. This is a very simplified definition of negative interest rate for better understanding of the concept.

For example, according to the regulatory requirements banks are required to keep reserve in the central bank the central bank pays interest on these reserves, however, in negative interest rate scenario, the CB charges banks rather than giving interest on the balance reserve.

Theoretical underpinnings of negative interest rate

Negative interest rate is quite a new phenomenon and many economists are quite puzzled by this new development after the global financial crisis of 2008/2009 and warned about its negative consequences. The fundamental monetary theory behind applying this unusual monetary phenomenon works as follows. When the economy is slowing down or in recession with very low inflation or even deflation, consequently very low or negative rate of growth due to lack of investment activities in the economy because of political and economic uncertainty, regional geopolitical instability, plummeting capital and commodity markets, slowing down of major economies like China, Japan, the EU and the USA. Banks, key financial intermediaries, are very reluctant to disburse loan to customers, especially to small and medium enterprises, which only aggravate the overall economic conditions as moral hazard and adverse selection increase during recession. In this situation, in order to stimulate the economy and create some sort of inflationary expectation central banks run expansionary monetary policy and cut their interest rate drastically which may actually go down below zero or close to zero, which is known as zero lower bound. In other words, this unprecedented initiative is due to excessive liquidity in the financial system, that is, people put their money in the bank and the bank invests in safer government securities and not lending or investing in real sector activities which prolong the economic recession. Even though negative interest have worked so far within the institutional framework, between central banks and commercial banks, however, some banks in Europe have started charging negative interest rate against high net worth depositors.

Islamic finance theory and negative interest rate

Prohibition of *Riba* is one of the fundamental principles in Islamic finance theory which distinguishes it from its conventional counterpart. As many scholars argue that in Arabic the term *Riba* has different meanings, however most commonly accepted opinion is that it is derived from the derivative word "raba-wa" which has certain meanings as to increase, to grow, to grow up, to exceed, be more than etc. *Riba* is generally translated into English as usury or interest but in fact it has much broader sense under *Shari'ah* (Haqqi, 2009; p.123-124).

On *Riba*, the direct Quranic references are to be found in four *surahs* or chapters. These verse are an ascending scale which starts with a mere judgment of value, followed by an implicit prohibition, then a limited one and finally, a total and conclusive prohibition (Al-Rum, 30:39; Al-Nisa, 4:161; Ali-Imran, 3:130 and Al-Bakarah, 2:275-9). [2] In addition to that, many *Hadiths*, sayings and traditions of the Prophet (SAWS) restated the prohibition of *Riba.*[3] In classical fiqh, usurious transactions are classified into two categories: a) *Riba al-fadl, and* b) *Riba al-nasi'ah.* Haqqi(2009) states that some scholars added a third category of *Riba* named *Riba al- jahiliyah* or

[2] Ali, A. Y. (2004). *The Meaning of the Holy Qu'ran.* Amana Pubns.

[3] Muslim, Sahih, vol. III, p. 1211 &1218, hadith no. 1597; al-Bukhari, Muhammad ibn Ismail, (1407/1987), 1st ed., vol. III – al-Shaikh Qasim al-Rifai(edt), Beirut: Dar al-Qalam, pp. 128-9, hadith no.337

pre-islamic *Riba*, often manifested by the lender asking the borrower at maturity date if he will settle the debt or increase it.

The coming up of negative interest rate raise the old question in a new context. Is negative interest rate really *Riba?* There is no straight forward answer to this question as the issue is quite new in conventional economics and finance let alone in Islamic finance; moreover, so far interest rate is way above zero in most of the countries where Islamic finance has been practiced widely. In this background, we would like to explore whether existing literature provides any theory regarding whether negative interest rate is justifiable in Islamic finance theory.

While defining *Riba*, El-Gamal(2006) argues that *Riba* has no precise translation in English dictionary and criticizes those who misinterpret it simply as excessive or usurious payment of interest. He further argues that prohibition of *Riba* should be interpreted as an institution for improving economic efficiency and social justice. For example, requiring contracts to clearly specify fluctuating equity stakes (i.e., marking asset values to current market prices), without using conventional credit and interest rate financing, may help avoid counter-party risk and save costs of contract enforcement in the event of bankruptcy. Similarly, prohibition of *Riba* can be interpreted as incentivizing myopic decision makers to use mutually owned profit/loss sharing as a commitment device that helps avoid temptation and produces greater accumulations of capital, anticipating by centuries the literature in behavioral economics on dynamic inconsistency.

From contractual point of view, Muhammad Yusuf Saleem argues, in response to an e-mail, that if the contract with the customer is a loan contract then it is not valid to return less than the principal unless the lender voluntarily agrees to take less. It is valid if the relationship with the customers is based on risk sharing *mudarabah or musharakah* contracts.[4]

In the current Islamic banking setting, where fixed rate *murabaha* dominates the asset side but floating rate, profit and loss, dominates the liability side, negative interest would squeeze the profit of Islamic banks but would be less affected than conventional banks in the short run due to inherent balance sheet structure.

If we analyze the classical text, the real logic behind prohibition of interest rate is actually inherent injustice; it may be to borrower or lender. There is no ruling or fatwa regarding negative interest rate so far as it is not an issue in any Muslim countries or jurisdiction where Islamic finance is being practiced. However, by following the analogy of injustice in *Riba*, we can argue that negative interest rate should be equated wtih *Riba*.

***Mudarabah* investment deposit vs conventional savings account**

One of the most controversial issues in current Islamic banking practice is that the return on *Mudarabah* investment deposits and interest rate on savings accounts are quite identical if not the same. There are many facets of this issue.

First, this is evident, as Islamic and conventional banking are working in one economic system, the rate of return or interest rate tend to converge. **Second**, although from theoretical ground it is not acceptable but when Islamic banks set expected *mudarabah* deposit profit rates, they follow conventional benchmark interest rate in order to be competitive. The argument here is that people are generally interested in higher return with minimum or same amount of risk, so, if Islamic banks give lower profit than conventional banks, there is a displaced commercial risk, depositors in Islamic bank would withdraw their deposit and put them in conventional banks. If

[4] Uddin M.A (2016, March 21). Email Interview with Prof. Muhammad Yusuf Saleem.

Islamic banks pay more profit to depositors, more depositors would come to Islamic banks. In this way, the rate of return and interest rate would come to equilibrium in a dual banking system. But in reality, the size of Islamic banks are too small to compete with the large conventional banks, if Islamic banks try to offer higher profit rate or according to real rate of return on investment, the conventional banks can even come up with more aggressive banking, where survival of Islamic banks would be in danger. **Third**, as financial intermediaries, banks lend or invest depositors' money and earn profit or interest to pay depositors, in this way, conventional banks make profit on the spread of interest rate and Islamic banks on the spread of profit rate. Even though theoretically speaking Islamic banks profit rate should depend more on real rate of return on real sector investment which tend to fluctuate based on the economic condition. But if we analyze the asset side of the bank, we would find that this side is dominated by fixed cost financing, predominately *Murabaha* and others rent based products like *Ijarah*. In line with this, when Islamic banks set their fixed murabaha markup, it does follow the conventional lending interest rate including other operating and overhead costs. This means Islamic banks asset side is more or less similar to conventional banks, the question is how the liability side can be different when they are working in a dual banking system.

Delinking profit rate from the interest rate

It is important to break the correlation between profit rates and interest rates in order to develop a positive image of Islamic finance. But working in a dual banking environment, as discussed earlier, it would be a daunting task for Islamic banks. However, the following measures and wholehearted effort can bring some positive changes. **Firstly**, regulatory measures like IFSA 2013 in Malaysia where clear rules and guidelines are enacted for Islamic banking operations. For example, banks cannot declare *mudarabah* investment deposits rates beforehand, profit smoothing is not allowed, so, no profit equalization reserve (PER) can be maintained. This kind of specific rules can really shape the Islamic banking practice. **Secondly**, it is necessary to develop financial infrastructure like investment account platform in Malaysia where depositors or investors can choose from pool of projects or ventures where to invest according to their risk-return profile with the help of bank's intermediation. **Thirdly**, create awareness among depositors of Islamic banks regarding the mechanism of their products. **Finally**, develop comprehensive Islamic economic framework: Islamic monetary policy, proper implementation of Islamic law of contracts, develop trust between banks and investors through regulatory framework and property rights.

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