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Insurability of Islamic Deposits and Investment Accounts

Discussion Paper

**Prepared by the Islamic Deposit Insurance Group of the
International Association of Deposit Insurers**

C/O BANK FOR INTERNATIONAL SETTLEMENTS
CENTRALBAHNPLATZ 2, CH-4002 BASEL, SWITZERLAND
TEL: +41 61 280 9933 FAX: + 41 61 280 9554
WWW.IADI.ORG

About Islamic Deposit Insurance Group

The Islamic Deposit Insurance Group (IDIG) was established in 2007 under the aegis of the Research and Guidance Committee of the International Association of Deposit Insurers (IADI). The Group is responsible for conducting research as well as developing and promoting guidance and core principles to enhance the effectiveness of Islamic deposit insurance systems, for the benefit of those countries seeking to establish or improve their Islamic deposit insurance system.

Table of Contents

I.	Definition of key concepts	1
II.	Executive Summary	3
III.	Introduction	4
IV.	Insurability of Islamic deposits and investment accounts	5
	A. Wadi’ah deposits	6
	B. Qard deposits	8
	C. Murabahah deposits	9
	D. Mudarabah investment accounts	11
	E. Wakalah investment accounts	13
V.	Permissibility of using deposit insurance to guarantee Islamic deposits and investment accounts	15
VI.	Other considerations in determining the insurability of Islamic deposits and investment accounts	16
	A. The product meets the definition of deposit	16
	B. The product has similar features to those of conventional insured deposits	17
	C. The product is offered to or accepted from unsophisticated customers	18
	D. The product represents a major source of funding in the banking system	19
VII.	Concluding remarks	20
	APPENDIX I: Excerpts of Shari’ah Rulings	24
	APPENDIX II: Detailed Murabahah Transaction in Islamic Fixed Term Deposit ..	38
	BIBLIOGRAPHY	39

I. Definition of key concepts

Current account is a deposit which is reported as a liability in the balance sheet of an institution offering Islamic financial services, and which is available on demand and directly usable for making payments through a variety of payment methods.

Investment accounts are non-principal guaranteed products accepted by institutions offering Islamic financial services based on Shari'ah contracts such as profit-sharing (mudarabah) and agency (wakalah).

Islamic deposits are principal guaranteed products accepted by institutions offering Islamic financial services based on Shari'ah contracts such as safe custody (wadi'ah), interest-free loan (qard), cost-plus (murabahah) and other debt-based contracts.

Kafalah means the conjoining of the guarantor's liabilities to those of the guaranteed, such that the debt or other responsibility of the original bearer is established as a joint liability of both parties.

Maslahah literally means benefit or interest. The term is also defined as the consideration which secures a benefit or prevents harm but is, at the same time, harmonious with the aim and objectives of Shari'ah, which consist of protecting the five essential values: religion, life, intellect, lineage and property.

Mudarabah investment account is a product in which the investor (account holder) contributes capital to an enterprise or activity that is to be managed by the entrepreneur (institution offering Islamic financial services). Profits generated by the enterprise or activity are shared in accordance with the terms of the mudarabah agreement, while losses are borne solely by the investor unless they are due to the entrepreneur's misconduct, negligence or breach of contract.

Murabahah deposit is a product in which the seller (depositor) sells to an institution offering Islamic financial services a specified kind of asset that is already in the seller's possession at cost plus an agreed profit margin (selling price), to be paid at a future date.

Qard deposit is a product in which the lender (depositor) lends funds to the borrower (institution offering Islamic financial services) for a specified period, with the understanding that the same amount as the loaned funds will be repaid to the lender at the end of the period.

Restricted investment account refers to funds accepted by institutions offering Islamic financial services, with certain restrictions as to where, how and for what purpose these funds are to be invested.

Savings account is a demand deposit reported as a liability in the balance sheet of an institution offering Islamic financial services. It may be available on demand but without a direct third-party payment feature, and there may be

payment restrictions, such as a limit on payments or withdrawals or a minimum length of time for deposits (fixed deposit).

Shari'ah means divine Islamic law that encompasses all aspects of human life as revealed in the Quran (sacred writings of Islam revealed by God) and the Sunnah (the way of life prescribed for Muslims on the basis of the teachings and practices of Prophet Muhammad and His interpretations of the Quran).

Tabarru' is the amount of contribution to be rendered by a takaful participant as a donation for fulfilling the obligation of mutual help, and to be used to pay claims submitted by eligible claimants

Takaful is derived from an Arabic word meaning 'solidarity', and is the concept whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.

Trust-based contract is a contract that establishes liability on trustees only in cases of negligence and misconduct by the trustee.

Unrestricted investment account refers to funds accepted by institutions offering Islamic financial services, without restrictions as to where, how and for what purpose these funds are to be invested in a pooled portfolio.

Wadi'ah deposit is a product in which the safekeeper (institution offering Islamic financial services) guarantees the safety of the deposit entrusted by the principal (depositor). The safekeeper may charge a fee for looking after the deposit and may pay hibah (gift) to the principal.

Wakalah investment account is a product in which the principal (account holder) appoints an agent (institution offering Islamic financial services) to carry out an investment on the principal's behalf.

II. Executive Summary

The Islamic banking industry has recorded an enormous increase in its assets, which have grown in tandem with its sources of funding, mainly in the forms of Islamic deposits¹ and investment accounts.² As Islamic deposits and investment accounts continue to grow significantly, a more comprehensive regulatory infrastructure is necessary to safeguard the resilience of the Islamic banking industry.

The protection of Islamic deposits and investment accounts under a deposit insurance system has generated much discussion in the Islamic finance fraternity as to whether or not the products, especially the latter, could, in the event of a bank failure, be covered under the system from the Islamic law (Shari'ah) viewpoint. In contrast to Islamic deposits, whose amounts are principal guaranteed, investment accounts are non-principal guaranteed products. Investment accounts also commonly form the bulk of customer funds held at institutions offering Islamic financial services (IIFS).³

Against this backdrop, the Islamic Deposit Insurance Group (IDIG) has prepared this paper to discuss issues relating to the insurability of Islamic deposits and investment accounts.

The IDIG views the discussion as vital to the development of deposit insurance coverage for Islamic deposits and investment accounts, and this paper endeavors to provide guidance on issues which could otherwise hamper efforts to provide common protection for both Islamic banking products and their conventional counterparts. This paper also takes into account the International Association of Deposit Insurer's Core Principles for Effective Deposit Insurance Systems Principle on Coverage, which provide guidance on determining the scope of deposit insurance coverage for countries that plan to extend their deposit insurance system coverage to Islamic deposits and investment accounts.

This paper presents a comprehensive discussion on the insurability of Islamic deposits and investment accounts under commonly used Shari'ah contracts offered by IIFS in various jurisdictions. In arriving at its conclusions, the IDIG looked to classical and contemporary Islamic literature to provide the justification with regard to the insurability of Islamic deposits and investment accounts by a deposit insurer. Based on the research on Islamic deposits and investment accounts which adopt Shari'ah contracts such as wadi'ah, qard, murabahah, wakalah and mudarabah, two conclusions can be drawn:

¹ For the purpose of this paper, Islamic deposits refer to deposits that adopt wadi'ah, qard or murabahah contracts only.

² For the purpose of this paper, investment accounts refer to investments that adopt wakalah, and mudarabah contracts only.

³ Institutions offering Islamic financial services refer to financial institutions that mobilise funds as deposits and investment accounts in accordance with Shari'ah rules and principles, and invest them in accordance with Shari'ah compliant investment and financing instruments.

- i. For Islamic deposits, Shari'ah requires an IIFS to guarantee the deposits and allows the deposits to be guaranteed by a third party⁴ such as a deposit insurer.
- ii. For investment accounts, Shari'ah prohibits an IIFS from guaranteeing the accounts but allows the accounts to be guaranteed by a deposit insurer, on the strict condition that it fulfills the criteria of independence.

While this paper explores the Shari'ah contracts commonly used in Islamic deposits and investment accounts, such as wadi'ah, qard, murabahah, mudarabah and wakalah, research on practices under other Shari'ah contracts such as musharakah is still ongoing.

When undertaking efforts to implement effective coverage for Islamic deposits and investment accounts, after satisfying the insurability aspect of Shari'ah contracts it is also important for the countries concerned to consider the general policies or public policy objectives of the deposit insurance system in providing protection for the products. Among the policies that can be considered are: the product meets the definition of a deposit; the product has similar features to those of conventional insured deposits; the product is offered to or accepted from unsophisticated customers; and the size of the product is large enough to impact the Islamic banking system.

III. Introduction

The Islamic banking industry has undergone rapid development, with the emergence of about 600 IIFS in more than 75 countries offering Islamic financial products. By 2012, IIFS assets had reached USD 1.1 trillion, a jump of 33% from the 2010 level of USD 826 billion. The surge in assets, spurred on by the hike in funding sources, mainly in the form of Islamic deposits and investment accounts, has called for a more comprehensive regulatory infrastructure to safeguard the resilience of the Islamic banking industry.

Generally, an Islamic deposit is defined as any unpaid balance of money received from or held on behalf of a person by an IIFS in the usual course of deposit-taking business, for which the IIFS is obliged to repay on a fixed day or on demand by that person or within a specified period of time following demand by that person, including any profit which is payable to that person. The normal types of Islamic deposits are savings deposit, current deposit and term deposit, which are commonly offered either under wadi'ah (safekeeping), qard (loan) or murabahah (sale) contracts.

⁴ A third-party guarantee is a contract separate from the principal contract created between depositors/investment account holders and the IIFS. The third-party guarantor is not and should not be a party to the principal contract. The third-party guarantor may or may not have an interest in the principal contract. The third-party guarantee contract may be entered into between the depositor/investment account holder and the third-party guarantor or between the IIFS and the third-party guarantor. A third-party guarantee contract is made to express the commitment or promise by a third-party guarantor to make good the depositors'/ investment account holders' deposits in the event of an IIFS failure. A consideration may be given to the third-party guarantor in return for the guarantee promised. In this paper, 'third-party guarantor' refers to deposit insurers that protect Islamic deposits/investment accounts.

One unique feature of an IIFS is that, in some countries, the bulk of IIFS customer funds are in the form of investment accounts, in which the principal amount is not contractually guaranteed by the IIFS during its normal course of deposit-taking business. Investment accounts constitute funds received by the IIFS from individuals and institutions, whereby the account holders authorize the IIFS to invest these funds, usually based on mudarabah (profit-sharing) or wakalah (agency).

In some jurisdictions, Islamic deposits include investment accounts; other jurisdictions do not treat investment accounts as part of Islamic deposits.

Islamic deposits and investment accounts may receive protection from either a conventional deposit insurance system or an Islamic deposit insurance system (IDIS) in the event of an IIFS failure. Currently, only Malaysia and Sudan have developed and implemented an IDIS. Other jurisdictions are still considering the feasibility and impact on financial stability in their country. Indonesia, Turkey and some other countries protect Islamic deposits and investment accounts under conventional deposit insurance. Jordan is currently amending its law to adopt an IDIS alongside its conventional deposit insurance system.⁵

The move to protect Islamic deposits and investment accounts in countries with an IDIS is driven by the need to have Shari'ah-compliant deposit insurance coverage and by the public policy objectives of the respective countries, whereas in countries where products are protected by a conventional deposit insurer, the move is made solely to meet public policy objectives.

This paper provides a comprehensive discussion on the insurability of Islamic deposits and investment accounts under various Shari'ah contracts offered by IIFS in different jurisdictions. Reference is made to both classical and contemporary Islamic literature, so as to provide justification with regard to the insurability of Islamic deposits and investment accounts by a deposit insurer. The paper also presents general policies adopted by deposit insurers⁶ in different jurisdictions in determining the insurability of Islamic deposits and investment accounts.

IV. Insurability of Islamic deposits and investment accounts

The Core Principles for Effective Deposit Insurance Systems, which serve as a voluntary framework for effective deposit insurance practice, state in Principle 9 (coverage) that "policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is". The Principle does not restrict

⁵ The Shari'ah arrangements for IDISs in Malaysia, Sudan and Jordan are discussed in the discussion paper "Shari'ah Approaches for the Implementation of Islamic Deposit Insurance Systems", prepared by the Islamic Deposit Insurance Group of the International Association of Deposit Insurers.

⁶ The policy descriptions are based on information from the Malaysia Deposit Insurance Corporation, Indonesia Deposit Insurance Corporation, Savings Deposit Insurance Fund (Turkey) and Jordan Deposit Insurance Corporation.

protection to conventional deposits only as it can also be applied to Islamic deposits and investment accounts, so long as all Shari'ah requirements and respective authority guidelines are complied with.

The design of deposits and investment accounts in IIFS takes various types and forms, to accommodate the demands of different customer profiles. These products are structured to vary in risk, return and maturity features. In addition, IIFS must operate in accordance with Shari'ah principles and respective authority guidelines as well as adopt Shari'ah-compliant contracts in designing their products.

For the purpose of this paper, Islamic deposits refer to deposits whose structure is based on wadi'ah, qard and murabahah contracts, while investment accounts are those that adopt the contracts of mudarabah and wakalah.⁷

The following sub-sections highlight the salient features of each Islamic deposit and investment account. Then, a discussion on guarantees by IIFS is presented, in order to provide a context to support the conclusion on the permissibility of protecting Islamic deposits and investment accounts by a deposit insurer.

Islamic Deposits

A. Wadi'ah deposits

Literally, wadi'ah is a contract in which a person, known as the principal, entrusts another person, known as the custodian, with an asset belonging to the principal for safekeeping.

In the Islamic banking industry, the contract is widely used in savings and current accounts. It is also used in Islamic negotiable instruments. Essentially, wadi'ah is a deposit for which the depositor's funds are guaranteed in full by the IIFS.

For wadi'ah savings and current accounts, the IIFS acts as custodian, accepting deposits from depositors who seek safe custody of their funds and absolute convenience in their use. Depositors are the principals under this contract. After accepting the funds, the IIFS may utilize them in profitable investments. Customers may withdraw part or all of their fund balances at any time, and the IIFS guarantees the refund of such balances at any time.

i. Guarantee by custodian (IIFS)

Essentially, wadi'ah contracts entail safekeeping with guarantee. As such, the IIFS as the custodian is obliged to guarantee the entrusted deposits under all circumstances. If deposits are lost during the safekeeping tenure, the custodian is responsible providing compensation in respect of the entrusted funds, regardless of whether the loss is due to custodian's negligence or not.

⁷ This categorization is predominantly based on global practice for Islamic deposits and investment accounts.

The Organization of Islamic Cooperation (OIC) Fiqh Academy⁸ states that money deposited with an IIFS under a wadi'ah contract may be used by the IIFS for its trading activities, upon which the money must be guaranteed by the IIFS and returned on demand to depositors.⁹

A ruling by a Shari'ah authority¹⁰ resolved that the contract of wadi'ah is equivalent to a loan contract,¹¹ in which the deposit kept under the principle of wadi'ah with an IIFS must be guaranteed and refunded to the depositors upon request according to the agreed terms and conditions.

ii. Guarantee by deposit insurance system

From the Shari'ah viewpoint, a wadi'ah contract allows for multiple guarantees.¹² This means that additional guarantees by any parties, including a third party, can be attached to the contract.

One Shari'ah authority,¹³ for instance, allows a deposit insurer, as third party to the wadi'ah contract, to guarantee the wadi'ah deposit as there is no restriction on the execution of guarantees by a deposit insurer on wadi'ah deposits.¹⁴

Wadi'ah contracts also permit third-party guarantees, because acting as a guarantor to a guarantor is a valid arrangement.¹⁵ Besides the guarantee already provided by the IIFS, an additional guarantee from a deposit insurer is allowed for wadi'ah contracts. Although the IIFS guarantees the deposits, it is also permissible for a deposit insurer to guarantee the deposits.

In conclusion, under the contract of wadi'ah, the IIFS as custodian must guarantee the deposit regardless of whether it has utilized the deposits or not. In the event of an IIFS failure, the obligation of the IIFS to guarantee the deposit remains effective. A deposit insurer, on the other hand, may act as a third-party guarantor in the event of an IIFS failure.

⁸ The OIC Fiqh Academy is an academy for advanced study of Islam based in Jeddah, Saudi Arabia. See Resolutions and Recommendations of the Council of Islamic Fiqh Academy 1985–2000 (2000), published by the Islamic Research and Training Institute of the Islamic Development Bank.

⁹ As stated in the book "Fundamentals of Islamic Banking" by Dr. Asyraf Wajdi Dusuki and Dr. Nurdianawati Abdullah, published by the Islamic Banking and Finance Institute Malaysia in 2011.

¹⁰ Shari'ah Advisory Council (SAC), the highest point of reference on matters of Islamic finance in Malaysia.

¹¹ Resolution No. 65: Adaptation (Takyif) of Wadi'ah Yad Dhamanah as Qard, Shariah Resolutions in Islamic Finance, Bank Negara Malaysia (Central Bank of Malaysia), 2010.

¹² Article No. 627, Al-Majelle.

¹³ Shari'ah Advisory Council (SAC), the highest point of reference with regards to matters in Islamic finance in Malaysia.

¹⁴ Article No. 111. Guarantee Limit for Islamic Banking Deposits by PIDM, Shariah Resolutions in Islamic Finance, Bank Negara Malaysia (Central Bank of Malaysia), 2010.

¹⁵ Article No. 626, Al-Majelle.

B. Qard deposits

Qard is a non-interest bearing loan intended to allow the borrower to use the loaned funds for a period, with the understanding that the same amount as the loaned funds will be repaid at the end of the period.

For example, for a loan of USD 100 the same amount, i.e. USD 100, should be returned. The stipulated returned amount should not be more than USD 100 as any increment imposed by the lender or borrower on the returned amount would be tantamount to a loan with interest. Under a qard contract, there should be no promise of interest or consideration either by the lender or the borrower. However, the borrower, at his own discretion, is allowed to return an amount in excess of the borrowed amount to the lender, as long as the excess amount and the act of rewarding the excess amount are not stated in the qard contract and does not constitute a practice (uruf) to avoid riba.

In contemporary IIFS, qard contracts are normally used to structure savings and current accounts, particularly in Middle Eastern countries.¹⁶ Among recent developments in Islamic deposits, the principle of qard is also being used in gold investment accounts.¹⁷

Under the qard contract, depositors are deemed to be lenders when they place their money with the IIFS. The IIFS is deemed to be a borrower which may utilize the money in any way it deems appropriate. Depositors have the right to get back the amount they deposit or loan to the IIFS whenever demanded.

i. Guarantee by borrower (IIFS)

According to one of the most prominent Islamic schools of jurisprudence, in order for an object or asset to be guaranteed, the object or asset must be an established liability.¹⁸ A qard contract is a debt contract which imposes a liability on the borrower. Another opinion that allows the guarantee of qard contracts is made on the justification that qard is a transfer of ownership in wealth to a person on whom it is binding to return similar wealth.¹⁹

As such, under the qard contract, the IIFS as borrower must guarantee qard deposits because the IIFS has the liability and obligation to repay the amount established against it to the depositors. In the event of a loss of deposits, the IIFS must also guarantee the deposits, regardless of whether it has been negligent or not.

ii. Guarantee by deposit insurance system

A third party such as a deposit insurer is allowed to provide a guarantee for a qard contract enforced between an IIFS and a depositor. As with a wadi'ah contract, this permissibility is based on the fact that acting as a guarantor to

¹⁶ www.islamicbankingway.com/2010/11/19-saving-current-account-deposits.html (accessed 28/8/2012).

¹⁷ Al Rajhi Bank (Malaysia) offers gold investment accounts based on the principle of qard.

¹⁸ Islamic Financial System Principles and Operations, published by the International Shariah Research Academy in 2011.

¹⁹ Standard No. 19, AAOIFI Shariah Standards for Islamic Financial Institutions 1432H – 2010.

a guarantor of a qard contract is a valid arrangement.²⁰ It is also permissible to have more than one guarantor in a qard contract.²¹

In addition, if a person becomes a guarantor for the debt of another person, the guarantee is considered valid.²² This means that a deposit insurer is allowed to provide a third-party guarantee for qard contracts between an IIFS and a depositor.

It was mentioned under the section on wadi'ah that it is equivalent to a loan or qard contract. Thus, the justification that allows third-party guarantees for wadi'ah contracts may also be valid for qard contracts.

In conclusion, for deposits based on a qard contract, the IIFS as the borrower is obliged to guarantee the deposit. The deposits constitute a debt which the IIFS must return. A deposit insurer, on the other hand, may act as third-party guarantor for the qard contract. In the event of an IIFS failure which results in the IIFS's inability to return the deposit to the depositor, the deposit insurer as third-party guarantor may pay the deposit to the depositors.

C. Murabahah deposits

Murabahah refers to the sale of a commodity at the price for which the seller originally purchased it, plus a specified profit known to both seller and buyer. It is a cost-plus-profit sale in which the seller expressly discloses the profit he intends to make. Murabahah in its original connotation simply means a profit. The main parties involved in a murabahah transaction are the seller and the buyer.

Currently, the concept of murabahah is being widely and extensively employed by the Islamic banking system to structure Islamic term deposit accounts, investment accounts, structured products such as investments linked to derivatives, short-term deposits such as money market deposits, negotiable instruments of deposit and Islamic negotiable instruments.

In these products, two stages of sale transactions actually take place, which are collectively referred to as a tawarruq arrangement. Other terms used to describe the arrangement are commodity murabahah or reverse murabahah. These terms are used interchangeably. However, for the purpose of this paper, deposits that adopt this arrangement shall be referred to as murabahah deposits, as murabahah is the underlying principal used in the products.

In a deposit based on a murabahah contract, the IIFS acts as the buyer and the depositor acts as the seller. Several brokers are involved to assist the transaction between the two parties. The underlying transaction that takes place in this deposit involves the depositor selling a commodity to the IIFS via brokers.²³

²⁰ Article No. 626, Al-Majelle.

²¹ Article No. 627, Al-Majelle.

²² Article No. 630, Al-Majelle.

²³ Refer to Appendix II for a detailed explanation of the transactions underlying an Islamic term deposit account.

The price of the commodity sold by the depositor to the IIFS is the cost price plus a certain profit margin. The IIFS must pay the price of the commodity to the customer on a deferred basis within the fixed tenure agreed between both parties. The fixed tenure is the term to maturity of the deposit instrument.

i. Guarantee by buyer (IIFS)

Subsequent to the above murabahah transaction, the IIFS – as buyer of the commodity – is liable for honoring the deferred sale payment to the depositor or seller by the time the deposit matures. At maturity, the depositor should receive the sale price of the commodity.

Under the murabahah contract, the IIFS must guarantee the sale payment. This is based on the Shari'ah ruling which states that contracts of exchange, for instance a contract of sale, may contain a guarantee element.²⁴

Another Shari'ah ruling states that a guarantee is allowed for a known debt for which payment is binding in the future. This ruling reinforces the IIFS's role to guarantee the sale price for a deposit structured on a murabahah contract²⁵.

In the deposit instrument discussed here, a sale transaction takes place between the depositor and the IIFS. In this sale, the cost price and the profit margin from the sale of the commodity constitute the principal and profit of the deposit, and are payable at the maturity of the deposit. Therefore, it is permissible for the IIFS to become the guarantor of the deferred payment price to the depositor after it has purchased the commodity from the customer.

ii. Guarantee by deposit insurance system

A deposit insurer is allowed to provide a guarantee for murabahah contracts between an IIFS and a depositor, in the sense that the deposit insurer may guarantee the deferred payment which the IIFS must pay to the depositor.

A third party is allowed to provide a guarantee in a murabahah contract based on the same arguments used for third-party guarantees in wadi'ah and qard contracts, whereby acting as guarantor to a guarantor is a valid arrangement²⁶ and more than one guarantor is permissible²⁷.

In conclusion, under the contract of murabahah, the IIFS must guarantee the principal and profit of the deposit upon maturity of the deposit instrument, because the IIFS is a debtor who buys a commodity from a seller (depositor). A deposit insurer, on the other hand, may act as a third-party guarantor in the event of an IIFS failure which results in the IIFS's inability to deliver the principal and profit to depositors. In this case, the deposit insurer guarantees that the principal and profit will be delivered to the depositor upon the IIFS's failure.

²⁴ Standard No. 5, AAOIFI Shariah Standards for Islamic Financial Institutions 1432H – 2010.

²⁵ Al-Zuhayli, 2001.

²⁶ Article No. 626, Al-Majelle.

²⁷ Article No. 627, Al-Majelle.

Investment Accounts

D. Mudarabah investment accounts

Mudarabah is a contract in which an investor provides capital to an entrepreneur for him to generate profit. The investor is solely responsible for providing the capital while the entrepreneur is tasked with managing and working with the capital. The investor does not have control over management of the capital but can specify how and where the capital is to be invested. Mudarabah is a contract that essentially involves two parties: investor and entrepreneur. Mudarabah is also known as al-qirad and al-muqaradah in Middle Eastern countries.

Mudarabah is widely used by IIFS to design various investment instruments for a wide range of clients. Mudarabah contracts have been used for investment accounts, investments linked to derivatives products, interbank and money market placements, Islamic negotiable instruments, and sell and buy back agreements. The contract may also be employed for savings accounts, current accounts, short-term deposits and negotiable instruments of deposit.

Essentially, under a mudarabah investment account, the account holder as investor will authorize the IIFS as entrepreneur to manage and invest his capital for a profit. The profit, if any, will be shared according to a pre-agreed ratio between the account holder and the IIFS.

i. Guarantee by entrepreneur (IIFS)

In a mudarabah contract, the IIFS is not allowed to give any form of guarantee to the investor, neither on capital nor on the profit.

In cases where the investment venture incurs a capital loss, this must be entirely borne by the investor, while the entrepreneur receives nothing for his efforts in investing the capital as there is no profit to be shared. This is assuming that the work was done with due diligence, otherwise the entrepreneur could be held responsible for negligence, misconduct or breach of contract, which entail a capital guarantee from the entrepreneur.

In classical Islamic jurisprudence, it is unanimously held that losses under a mudarabah contract are to be borne by the investor and not the entrepreneur, as the latter's status is only that of a trustee.²⁸

The mudarabah contract is a trust-based contract which stipulates that the trustee is not liable for losses except in cases where the trustee breaches the terms of the contract, such as misconduct in respect of a mudarabah fund and negligence.²⁹ When committing any of these, the trustee shall become liable for the mudarabah capital.

However, contemporary Islamic jurists have studied the acceptable methods for guaranteeing capital in a mudarabah contract, and have identified that the

²⁸ Standard No. 13, AAOIFI Shariah Standards for Islamic Financial Institutions 1432H – 2010.

²⁹ Glossary of Terms and Contracts: Certificate in Islamic Finance and Banking.

use of two-tier mudarabah³⁰ allows the IIFS to guarantee the mudarabah capital of the account holder.

Under the two-tier mudarabah arrangement, the IIFS invests the account holder's capital with another party, with the consent from the account holder. As such, the IIFS acts as an intermediary between the account holder and the actual entrepreneur. In effect, the IIFS is responsible for guaranteeing the capital, as the capital is handed over to another party for investment.³¹ In contrast to a single-tier mudarabah, where the IIFS manages the day-to-day operation of the investment, in a two-tier mudarabah the day-to-day management of the investment is taken care of by the actual entrepreneur.

ii. Guarantee by deposit insurance system

The deposit insurer, as a third party to the mudarabah contract between the IIFS and the account holder, may guarantee an investment structured on a mudarabah contract.

This is based on an opinion that a third party who has no connection whatsoever with the entrepreneur may issue a guarantee, provided this is not included as a condition in the actual mudarabah contract between the investor and the entrepreneur. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and OIC Fiqh Academy, for instance, allow third-party guarantees from parties other than the entrepreneur, investment agent or business partner in respect of the liability for investment losses. However, this is on the condition that the guarantee given is not tied to the original mudarabah contract.

Mudarabah is a contract based on partnership.³² Some of the conditions of a partnership contract are that the third-party guarantor, i.e. the deposit insurer, is independent from the IIFS such that:³³

- The third-party guarantee contract between deposit insurer and IIFS shall be executed as a separate contract from the original mudarabah contract and be utilized to cover for any loss or depletion of capital;
- The deposit insurer as third-party guarantor is independent from the IIFS such that it shall not be a related party where an IIFS has majority ownership and/or a controlling interest in the deposit insurer; and
- The deposit insurer does not own or have a controlling interest in the IIFS.

In conclusion, under the contract of mudarabah, the IIFS as entrepreneur is not allowed to guarantee the investment, unless there has been negligence or mismanagement on the part of the IIFS in managing the investment. Special

³⁰ "Kafalah on Mudarabah", by Malaysia International Financial Centre (MIFC). Downloadable at: http://www.mifc.com/index.php?ch=menu_know_ftw&pg=menu_know_ftw_reso&ac=526&mode=view.

³¹ "Kafalah on Mudarabah", by Malaysia International Financial Centre (MIFC). Downloadable at: http://www.mifc.com/index.php?ch=menu_know_ftw&pg=menu_know_ftw_reso&ac=526&mode=view.

³² Resolution No. 105: Scope of Danajamin's Guarantee on Sukuk, Shariah Resolutions in Islamic Finance by Bank Negara Malaysia (Central Bank of Malaysia), 2010.

³³ Shariah Standard on Mudarabah by Central Bank of Malaysia.

conditions that allow the IIFS to guarantee mudarabah investments are the establishment of a special fund, and the use of a two-tier mudarabah arrangement. A deposit insurer, on the other hand, may act as a third-party guarantor in the event of an IIFS failure.

E. Wakalah investment accounts

Wakalah is a concept in which one person, known as the principal, empowers another person, or agent, to perform some task on the principal's behalf.

The application of wakalah contracts in IIFS can be seen in various investment instruments such as investment accounts, structured products such as investments linked to derivatives and short-term investments such as money market placements. Besides investment, wakalah is also used for deposits such as savings accounts and current accounts. These instruments are normally customized to suit the needs, financial expectations and investment goals of individual clients.

Generally, in a wakalah-based investment, the IIFS acts as an agent receiving capital from the account holder or investor, who is the principal.

For example, with a wakalah investment account, the investor will instruct the IIFS to invest the entrusted funds in an investment that can potentially generate a desired profit, for instance 5%. The entrusted funds may be invested by the IIFS in a list of authorized investments, including money market instruments, Islamic securities, unit trusts and so on. Some IIFS require the investor to pay a fee in consideration for the services provided by the IIFS.

i. Guarantee by agent (IIFS)

The IIFS should not guarantee the principal sum and profit of the investment under the wakalah contract. For instance, if the IIFS invests the entrusted funds in an instrument that is expected to generate some profit but fails to reach the desired profit of 5%, the IIFS is not responsible for making good the desired profit. Say the profit realized from the investment is 3% instead of 5%, the IIFS should not make up the 2% shortfall in profit. In another example, if the investment does not make a return or the profit is 0%, the IIFS is not supposed to compensate the investor for any amount of the desired profit.

On the other hand, if, instead of a profit the investment makes a capital loss, such loss shall be borne by the investor, unless it is proven that the IIFS has been negligent or has breached the terms of the agreement by investing in instruments which have no potential to generate a profit.

If the IIFS has breached the terms of the agreement or has negligently invested in an instrument which has no potential to generate a profit, the IIFS will have to pay the principal sum as compensation.³⁴ As such, except in the case of negligence and misconduct, the IIFS as the agent is indemnified

³⁴ Resolution No. 66: Application of Wakalah bi al-Istithmar in Deposit Product, Shariah Resolutions in Islamic Finance by Bank Negara Malaysia (Central Bank of Malaysia), 2010.

against losses as a result of any transaction entered into in the course of managing and investing the fund.

In this regard, a Shari'ah ruling mentions that "... a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest-based loan, since the capital of the investment is guaranteed in addition to the proceeds of the investment (i.e. as though the investment agent had taken a loan and repaid it with an additional sum which is tantamount to riba)."³⁵

The agent in a wakalah contract is considered as a trustee³⁶ when holding the entrusted funds, in this case the investment capital. Wakalah is a Shari'ah contract based on the concept of trust, which means that the agent is not liable to guarantee the entrusted funds except in cases of the agent's negligence and misconduct in managing the funds.

Thus, the agent is not allowed to guarantee the funds entrusted to him by the principal. The principal bears any loss or damage incurred by the funds, unless the agent has been negligent when managing the principal's funds.

Therefore, the IIFS, as agent and trustee in the wakalah contract, is not bound to indemnify the loss of capital and profit. The IIFS shall be held responsible only when the damage results from the IIFS's misconduct or breach of terms or stipulations of the contract.

ii. Guarantee by deposit insurance system

A deposit insurer, as a third party to a wakalah contract between an IIFS and an investor, may guarantee an investment structured on a wakalah contract.

A third-party guarantee in an investment is a voluntary undertaking to compensate an investment loss. It is permissible for a third party, other than the investment agent or one of the partners, to undertake voluntarily that he will compensate the investment losses of the party to whom the undertaking is given, provided this guarantee is not linked to any manner to the investment agency contract.³⁷

Investments structured on the principle of wakalah are identical to investments structured on the principle of mudarabah because the agent receives the capital money from the customer for the purpose of investment.³⁸

Wakalah is also a contract based on partnership.³⁹ This means that the third-party guarantor for an investment based on a wakalah contract must meet the

³⁵ Standard No. 5, AAOIFI Shariah Standards for Islamic Financial Institutions 1432H – 2010.

³⁶ Standard No. 23, AAOIFI Shariah Standards for Islamic Financial Institutions 1432H – 2010.

³⁷ Standard No. 5, AAOIFI Shariah Standards for Islamic Financial Institutions 1432H – 2010.

³⁸ Resolution No. 66: Application of Wakalah bi al-Istithmar in Deposit Product, Shariah Resolutions in Islamic Finance by Bank Negara Malaysia (Central Bank of Malaysia), 2010.

³⁹ Resolution No. 105: Scope of Danajamin's Guarantee on Sukuk, Shariah Resolutions in Islamic Finance by Bank Negara Malaysia (Central Bank of Malaysia), 2010.

independence conditions⁴⁰ discussed above, in the section on mudarabah investment accounts.

In conclusion, for investments based on a wakalah contract, an IIFS which acts as an agent is not allowed to guarantee the investment, unless there has been negligence or mismanagement on the part of the IIFS in managing the investment. A deposit insurer, on the other hand, may act as a third-party guarantor to an investment based on a wakalah contract, in the event of an IIFS failure which results in the IIFS's inability to deliver its obligations to investors.

V. Permissibility of using deposit insurance to guarantee Islamic deposits and investment accounts

Based on the above discussion, a conclusion can be drawn with regard to the permissibility of protecting Islamic deposits and investment accounts through a deposit insurance system. For Islamic deposits, a guarantee by a deposit insurer is allowed as the deposits are guaranteed by the IIFS, and Shari'ah law allows third-party guarantees. Investment accounts are not guaranteed by the IIFS but Shari'ah allows them to be guaranteed by a third party, i.e. a deposit insurer, on the strict condition that it fulfills the criteria of independence as discussed. The third-party guarantees submitted by contemporary Shari'ah scholars are based on kafalah (guarantee), tabarru' (donation) and qard⁴¹ contracts.

The following table summarizes the permissibility of deposit guarantees from an IIFS and a third party (deposit insurance system):

Deposits and investment accounts	IIFS allowed to guarantee?	Third party (e.g. deposit insurer) allowed to guarantee?
Wadi'ah deposits	Yes	Yes
Qard deposits	Yes	Yes
Murabahah deposits	Yes	Yes
Mudarabah investment account	No	Yes
Wakalah investment account	No	Yes

⁴⁰ Shariah Standard on Mudarabah by Central Bank of Malaysia.

⁴¹ "Kafalah on Mudarabah", by Malaysia International Financial Centre (MIFC). Downloadable at: http://www.mifc.com/index.php?ch=menu_know_ftw&pg=menu_know_ftw_reso&ac=526&mode=view

VI. Other considerations in determining the insurability of Islamic deposits and investment accounts

Eligibility for deposit insurance coverage is fundamental when extending deposit insurance protection to Islamic deposits and investment accounts in the Islamic banking system. In the previous section, the paper discusses the insurability of Islamic deposits and investment accounts offered under various Shari'ah contracts from the Shari'ah standpoint. Based on the discussion, it can be concluded that it is permissible for a deposit insurer, as a third party, to provide a guarantee on Islamic deposits and investment accounts.

Nonetheless, the approach to guaranteeing investment accounts warrants further attention as there is an ongoing debate on the approach, which needs to be in line with Shari'ah. This is, however, not discussed in this paper.

In the following section, the paper will briefly discuss the criteria that can be considered in determining the insurability of Islamic deposits and investment accounts, particularly the specific type of products. Such criteria will be further examined using the survey results gathered from Malaysia, Indonesia, Turkey and Jordan on deposit insurance practice. The survey drew on these countries' experiences for practical insights into how the eligibility of Islamic deposits and investment accounts for insurance coverage is being handled. Besides the survey, information was also obtained from other secondary sources.

The insurability criteria should be established based on the respective jurisdiction's public policy objectives. As these objectives may differ from one country to another, it is important that policymakers tailor and customize the eligibility criteria to align with the country's public policy objectives, as there is no one-size-fits-all approach that addresses the matter.

A. The product meets the definition of deposit

A product may be considered for protection under deposit insurance if it meets the definition of deposit as provided by the law, in which a deposit is commonly defined as a principal guaranteed product. As such, this criterion is not applicable to investment accounts. However, investment accounts that exhibit the features of deposits may fall under the definition of deposit and may be considered for protection.

In Malaysia, the Malaysia Deposit Insurance Corporation (MDIC) protects Islamic savings accounts, Islamic current accounts and Islamic term deposits. Unrestricted investment accounts and restricted investment accounts accepted under the repealed Islamic Banking Act 1983 (IBA) are also protected by the MDIC because the accounts are treated as deposits. As for investment accounts accepted under the new Islamic Financial Services Act 2013 (IFSA), the accounts are not protected because they are not treated as deposits.

In Indonesia, Islamic deposits apply the principles of wadi'ah or mudarabah only. Indonesia's Shari'ah banking law of 2008 rules that Islamic deposits under wadi'ah contracts are regarded as deposits and Islamic deposits under mudarabah contracts are regarded as investments.

Indonesian banking law stipulates that current accounts, savings accounts, term deposit accounts and their Islamic equivalents, regardless of the Shari'ah contracts used, fall under the definition of deposit. Therefore, the Indonesia Deposit Insurance Corporation (IDIC) protects these equivalent Islamic accounts.

In Turkey, the main policy that determines the insurability of an Islamic deposit by the Savings Deposit Insurance Fund (SDIF) stipulates that a product needs to be in line with the definition of deposit as provided by the law.

The SDIF protects participation funds, which consist of demand deposits (current accounts) and term deposit accounts.

Under Turkey Banking Law No. 5411, deposits and participation funds are defined separately as follows:

"Deposit is money accepted by announcing to the public, verbally or in writing or in any manner, in return for or without a consideration or to be returned on a certain date of maturity or whenever it is called."

"Participation fund is the funds at special current and participation accounts opened at participation banks by natural and legal persons."

"Participation account is the accounts constituted by funds collected by participation banks that yield the result of participation in the loss or profit to arise from their use by these institutions, that do not require the payment of a pre-determined return to their owners and that do not guarantee the payment of the principal sum."

Although deposits and participation funds are defined separately, Article 111 of Turkey Banking Law No. 5411 stipulates that one of the duties of the SDIF is to insure deposits and participation funds in order to protect the rights and interests of depositors.

In the case of Turkey, the money residing in participation banks (IIFS) is defined separately from deposits. If Turkey had used "meeting the definition of deposits" as the sole criterion for what to protect under its deposit insurance, participation funds would not have been protected. However, Turkey is mandated by law to insure participation funds in addition to deposits. Therefore, participation funds are protected.

In Jordan, most deposit accounts, such as current and demand deposits, savings deposits, term deposits, deposits subject to notice, and unrestricted investment accounts, are protected. Only restricted investment accounts are not considered eligible for protection.

B. The product has similar features to those of conventional insured deposits

Another important aspect that can be a criterion for the insurability of an Islamic product is that the features of the product are similar to those of conventional insured products. This is in view of the need to create a level playing field in

respect of deposit insurance protection for both the Islamic banking system and the conventional banking system.

Many countries where Islamic finance is practised apply a dual banking system, in which the Islamic banking system operates alongside the conventional system. Malaysia, Turkey, Indonesia and Jordan implement a dual banking system.

In a dual banking system, it is important that Islamic and conventional deposits receive comparable deposit insurance coverage, to ensure a level playing field between the two systems and to promote the competitiveness of Islamic deposits. If there is unequal protection of the two systems, deposits may flow out of the banking system that receives lower deposit insurance protection or no protection at all, to the system that has better protection.

In Malaysia, it is the MDIC's policy to create a level playing field between the Islamic and conventional banking systems, whereby the scope of the MDIC's coverage for Islamic products needs to be comparable to that for conventional deposit products. As such, deposits such as savings accounts, current accounts and fixed deposits/term deposits under both systems are protected by the MDIC. In addition, unrestricted investment accounts and restricted investment accounts under the IBA that are treated as deposits are also protected by the MDIC, because the expectations of both sets of account holders are similar to those of holders of conventional fixed deposit accounts and principal guaranteed investment-linked products.

In Indonesia, the IDIC also has a policy of creating a level playing field between the Islamic and conventional banking systems. The scope of IDIC coverage for Islamic deposit products needs to be comparable to that for conventional deposit products. Hence, deposits such as savings accounts, current accounts and fixed deposits/term deposits under both systems are protected by the IDIC.

Similarly in Turkey, the SDIF strives to create a level playing field between the Islamic and conventional banking systems. Therefore, the scope of SDIF coverage for IIFS must be similar to that for conventional banks. As such, demand deposit and fixed deposits/term deposits of both types of banking system are protected by the SDIF.

In Jordan, the same scope of coverage is applied by the Jordan Deposit Insurance Corporation (JODIC) to both conventional and Islamic deposits, in the spirit of achieving a level playing field for the two systems.

C. The product is offered to or accepted from unsophisticated customers

The main objective of a deposit insurance system is to avoid bank runs by small and uninformed depositors. It is important to consider protection for products offered to or accepted from unsophisticated depositors and investment account holders, as they are generally not in the position to make an informed assessment of the risk that the bank to which their funds are entrusted may fail. Uninformed or unsophisticated depositors and investment account holders are also sometimes referred to as household or retail depositors and investment account holders.

The MDIC protects unsophisticated depositors and investment account holders (i.e. accounts under the IBA), which significantly comprise individuals who are holders of Islamic savings accounts, Islamic current accounts, Islamic term deposits and unrestricted investment accounts. The MDIC's current deposit insurance coverage limit protects 99% of depositors in full. In Malaysia, Islamic negotiable certificates of deposit are not protected by the MDIC because the protection of such deposits does not meet the objective of protecting unsophisticated depositors, since most of its holders are sophisticated depositors who are well informed of the risks associated with the deposit they are holding, and are able to exert market discipline on banks. Investment accounts under the IFSA are also not protected by the MDIC because the products are offered to sophisticated customers.

The IDIC also strives to protect unsophisticated depositors and investment account holders, the majority of which are individuals. The IDIC law stipulates that it must cover at least 90% of depositors and investment account holders in full. Currently, the IDIC's deposit insurance coverage limit protects 99% of depositors and investment account holders in full, and most protected depositors and investment account holders are individuals who have Islamic savings accounts, Islamic current accounts and Islamic time deposits.

Unlike the MDIC and the IDIC, the SDIF protects individual depositors only. The SDIF's current deposit insurance coverage limit protects 88% of depositors of IIFS in full.

In Jordan, depositors of IIFS account for 35% of total depositors, and deposits held at IIFS represent 19% of total deposits. By protecting this portion, JODIC extends its protection to 98% of depositors, who represent the less sophisticated depositors. Restricted investment accounts, where an IIFS act as agent, are not protected as the investors are more sophisticated and are supposed to evaluate the risks of the projects they choose to invest in.

D. The product represents a major source of funding in the banking system

In defining what constitutes an insurable deposit, policymakers should consider the relative importance of different deposit instruments within the banking system. It makes sense to protect those types of deposits whose share in the banking system is large enough to have an impact on banking system stability.

In Malaysia, the criteria for insurable Islamic deposits consider the size of a deposit type relative to total Islamic deposits in the Islamic banking system. The size of the deposit type indicates its importance in the system insofar as a mass withdrawal of such deposits at any one time could trigger a bank run. Islamic savings accounts, Islamic demand deposit accounts, Islamic term deposits and unrestricted investment accounts (i.e. investment accounts under the IBA) represent a huge portion of total Islamic deposits in the Islamic banking system and are therefore protected by the MDIC.

In Turkey, the insurability of Islamic deposits by the SDIF is also determined by the size of a specific type of deposit relative to total Islamic deposits in the

Islamic banking system. Islamic demand deposit accounts and Islamic term deposits of individual depositors represent a major portion of total Islamic deposits in the Islamic banking system and are therefore protected by the SDIF.

In Jordan, considerations of insurability are based on the size of deposits and the perception of depositors. Current and demand deposits, savings deposits, term deposits, deposits subject to notice, and unrestricted investment accounts held with IIFS constitute a considerable portion and are consequently protected by JODIC.

VII. Concluding remarks

This paper has extensively discussed the insurability of Islamic deposits and investment accounts from the Shari'ah perspective, and gives a preview of other insurability considerations that form the public policy objectives of selected deposit insurers.

From the Shari'ah point of view, all Shari'ah contracts that form the underlying structure of deposit instruments and investment accounts may be protected and guaranteed by a deposit insurance system which acts as a third party to the contracts between account holders and the IIFS. While Shari'ah allows the above, under certain circumstances, the public policy objectives are used as the basis of Shari'ah. A conduct or practice is allowed if it meets the objective of Shari'ah, which is to benefit the general public.

For instance, according to Shari'ah, an Islamic negotiable certificate of deposit based on a mudarabah contract may be protected by a deposit insurer. However, protecting this type of deposit may not be in line with the general objective of deposit insurance, which is to protect unsophisticated depositors, as most holders of negotiable certificates of deposit are sophisticated depositors who are well informed of the risks associated with the deposit they are holding. Protecting this product may also create moral hazard as both banks and depositors would indulge in excessive risk-taking behavior despite having a sound knowledge of the product risks.

This paper is intended to provide guidance and suggestions, since deposit insurance systems operate under different environmental factors in different countries. Thus, practitioners may devise other eligibility criteria that are more appropriate to their jurisdictions and the unique factors of their environments.

APPENDIX I: Excerpts of Shari'ah Rulings

Footnote 11:

Shariah Resolutions in Islamic Finance, 2010 (Resolution No. 65 on Adaptation (Takyif) of Wadi'ah Yad Dhamanah as Qard):

"The SAC was referred to on the issue as to whether the ruling applicable on qard may also be adapted or applied in wadi'ah yad dhamanah.

Resolution

The SAC, in its 6th special meeting dated 8 May 2008, has resolved that the ruling on wadi'ah yad dhamanah which involves money may also apply the rules of qard in terms of its parameters (dhawabit) and its subsequent effects.

Basis of the Ruling

The aforesaid SAC's resolution is based on the following considerations:

- i. In the current financial context, wadi'ah is a contract whereby the asset owner deposits his asset to another party on trust basis for safe keeping;*
- ii. Majority of fiqh scholars classify wadi'ah as a trust contract (yad amanah) whereby the deposited asset for the custody of the wadi'ah recipient is treated as a trust. The wadi'ah recipient is obliged to replace the wadi'ah asset within his custody in the event of damage or loss of the wadi'ah asset due to his negligence. Nevertheless, majority of scholars view that if the financial institution utilised the deposited money, the contract becomes a contract of qard;*
- iii. The OIC Fiqh Academy has resolved that "deposits in current accounts, either deposited at Islamic or conventional financial institution, is a kind of loan from fiqh perspective since the financial institution that receives the deposit guarantees such deposit and it must refund the deposit upon request"; and*
- iv. The contemporary scholars' view in relation to the rules on wadi'ah asset deposited at Islamic financial institutions is consistent with the view of classical scholars who held that the rulings of qard are applicable in the instance where the wadi'ah recipient utilised wadi'ah asset with the consent of wadi'ah depositor."*

Footnote 12:

Al-Majelle Article 627:

"A number of sureties is allowed."

Footnote 14:

Shariah Resolutions in Islamic Finance, 2010 (Resolution No. 111 on Guarantee Limit for Islamic Banking Deposits by PIDM):

"In executing the guarantee on Islamic banking deposits, the SAC was referred to on the issue as to whether PIDM may guarantee the principal value as well as the profit realised but not yet distributed by the Islamic banks.

Resolution

The SAC, in its 29th meeting dated 25 September 2002, has resolved that there is no restriction on the execution of guarantee on wadi'ah deposit. Mudarabah deposit, however shall only be guaranteed by a third party (in this situation, it may refer to PIDM). However, the insurance deposit shall not give priority to guarantee mudarabah profit that has not been declared.

Basis of the Ruling

The aforesaid resolution of the SAC is based on the following considerations:

- i. PIDM may limit the guarantee coverage as it is in line with the principle of kafalah that allows the kafil to determine the guarantee limit;*
- ii. There is no Shariah impediment in executing guarantee on deposit based on wadi'ah; and*
- iii. Deposit insurance should not give priority to guarantee mudarabah profit that has not been declared as it should be used to settle the claims and liabilities of higher priority."*

Footnote 15:

Al-Majelle Article 626:

"It is lawful to become surety for a surety."

Footnote 18:

Islamic Financial System – Principles and Operations: Chapter 7: Shari'ah contracts for Islamic financial instruments – Part 2: Basic Rules and Conditions of Kafalah:

"According to Hanafi, the object or asset of a guarantee contract must be an established liability (fungible, non-fungible, a person, or an action) (Al-Kasani, Al-Bada'i Al-Sana'i, 6/5)."

Footnote 19:

AAOIFI Shari'ah Standard No.19 on Qard (Loan) (Article 2: Definition of qard):
"Qard is a transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it."

Footnote 20:

Al-Majelle Article 626:

"It is lawful to become surety for a surety."

Footnote 21:

Al-Majelle Article 627:

"A number of sureties is allowed."

Footnote 22:

Al-Majelle Article 630:

"If a person becomes guarantor for the debt of another owing to some third person, the amount of such debt being unknown, a valid contract of guarantee is concluded."

Footnote 24:

AAOIFI Shari'ah Standard No.5 on Guarantees (Article 2/1/1):

"A contract of guarantee is permissible in contracts of exchange, e.g. a contract of sale, or contract of rights, e.g. right of intellectual property."

Footnote 25:

Dr. Wahbah Al-Zuhayli in "Financial Transaction in Islamic Jurisprudence" Volume 2: Chapter 58.5 Guaranteed object conditions:

"There is a consensus that guaranties of currently owed debts are valid if the debt is known. Moreover, there is a consensus that it is not permissible to guarantee debts prior to maturity if it is not certain that they will be binding in the future. However, the majority of jurists permit guarantee of debts prior to maturity if it is known that the debts will be binding in the future."

Footnote 26:

Al-Majelle Article 626:

"It is lawful to become surety for a surety."

Footnote 27:

Al-Majelle Article 627:

"A number of sureties is allowed."

Footnote 28:

AAOIFI Shari'ah Standard No.13 on Mudarabah (Article 4/4):

"Mudarabah contract is one of the trust-based contracts. Therefore, the mudarib is investing mudarabah capital on trust basis in which case the mudarib is not liable for losses except in case of breach of the requirements of trust, such as misconduct in respect of mudarabah fund, negligence and breach of the terms of mudarabah contract. In committing any of these, the mudarib becomes liable for the amount of the mudarabah capital."

Footnotes 30 and 31:

"Kafalah on Mudharabah Capital" published by Malaysia International Financial Centre (MIFC) at http://www.mifc.com/index.php?ch=menu_know_ftw&pg=menu_know_ftw_reso&ac=526&mode=view

The Original Law on Guarantees for Mudharabah Capital

According to the arguments of past Islamic jurisprudence, the jurists were unanimous in their opinion that when losses occur in a mudharabah contract, the loss is to be borne by the rabb mal and not the mudharib as the latter's status is only amin (trustee). However, if it could be proven that the loss was clearly due to the mudharib's negligence or intentional, then the mudharib is to make good the capital to the investor.

Past Islamic jurists were unanimously of the opinion that in a situation where a loss occurs on a mudharabah, a capital guarantee by the mudharib is not permissible. However, they have different opinions on the status of the contract. The Hanafi and Hanbali Mazhab were of the opinion that the contract is valid and the conditional guarantee should be nullified. The Maliki and Syafi'i Mazhab, however, were of the opinion that the mudharabah contract is immediately nullified if there is such a guarantee.

Contemporary Islamic jurists have made studies on the acceptable level of capital in mudharabah contracts that can be guaranteed according to the perspective of Islamic jurisprudence. The main issue of concern in relation to capital guarantee is whether the guarantee given will cause the mudharabah contract to be nullified since it violates the muqtadha 'aqd (the main objective of a contract).

They have submitted several solutions on mudharabah capital guarantee, including:

- (a) Third-party guarantee based on tabarru' (voluntarily given);*
- (b) Third-party guarantee based on qardh (debts);*
- (c) Mudharib yudharib (the entrepreneur channels the investor's capital to investing in a third party); and*
- (d) Guarantee through special funds.*

Third-Party Guarantee Based on Tabarru'

The OIC Fiqh Academy discussed on the matter of issuance of sanadat muqaradhah and summarised that mudharib guarantee on capital and mudharabah profits are not permissible. However, the guarantee may be issued by a third party who has no connection whatsoever with the mudharib if it is

done by way of *tabarru'* and is not included as a condition in the actual *mudharabah* contract sealed and signed by both parties. The Shariah Council for Accounting and Auditing Organization for Islamic Institutions (AAOIFI) allowed for third-party guarantees other than by *mudharib* or investment agent or business partner towards the liability of investment losses. However, this is on the provision that the guarantee given is not tied to the original *mudharabah* contract. The basis of their decision is *tabarru'* which is allowed by Shariah.

Husain Hamid Hassan summarised the basis of the permissibility of third-party guarantees based on the views of the Maliki Mazhab which allow *wa'd mulzim* (promises that must be kept). It is further strengthened by *maqasid Shariah* (Shariah's objective) which allows for such action.

Third-Party Guarantee Based on Qardh

The OIC Fiqh Academy, disagrees with the basis of third-party guarantees that are based on debt and resolved that third-party guarantees have to be in the form of *tabarru'*. Otherwise, the contract is deemed to be an interest-bearing debt which is not permissible.

Mudharib Yudharib

Past Islamic jurists also delved on the issue of *mudharabah* capital guarantee in the context of *mudharib yudharib*. The *mudharib* invests the capital received from *rabb mal* to another party. In other words, the *mudharib* acts as an intermediary between the first *rabb mal* and the actual entrepreneur. Wahbah al-Zuhaili summed up the views of past Islamic jurists on the issue of *mudharib yudharib* that all the four *fiqh* sects collectively agreed that the first *mudharib* shall be responsible for the liability of the guarantee (*dhaman*) if the capital is invested or handed over to another *mudharib* (third party).

Generally, the *mudharib yudharib* concept is allowable. If it bears any profit, the profit should be distributed between the *rabb mal* and the first *mudharib* based on a pre-agreed rate and the balance is to be distributed between the first *mudharib* and the second *mudharib*.

For financial institutions and companies that issue financial products based on *mudharabah*, the concept of *mudharib yudharib* may be applied if they invest part of the capital in other parties. If this happens, the financial institutions or companies should guarantee the capital based on the views of majority of Islamic jurists. Hence, in such a situation the interest of investors is guaranteed.

Guarantee Through Special Funds

Contemporary Islamic jurists also allow the channeling of a portion of *mudharabah* profits to a special fund created for the purpose of insuring against future losses. This may be done with the concurrence of investors."

Footnote 32:

Shariah Resolutions in Islamic Finance, 2010 (Resolution No.105 Scope of Danajamin's Guarantee on Sukuk).

"The SAC was referred to ascertain the scope of guarantee by Danajamin on the sukuk issuer, specifically on the issue as to whether Danajamin may guarantee capital and profit value.

Resolution

The SAC, in its 10th special meeting dated 9 April 2009, has resolved that:

i. For sale-based sukuk like murabahah, Danajamin shall guarantee both capital and profit value; and

ii. For sukuk issued based on isytirak contract (partnership) like musyarakah, mudarabah and wakalah bi al-istithmar, Danajamin shall guarantee the capital value only.

Basis of the Ruling

For sukuk issued based on isytirak contract like musyarakah, mudarabah and wakalah bi al-istithmar, Danajamin as a third party may only guarantee the amount of capital. This is in line with the jurists' view that third party guarantee is permissible for musyarakah, mudarabah and wakalah bi al-istithmar contracts but the guarantee is restricted only to the capital value."

Footnote 33:

Shariah Standard on Mudarabah

14.1 Mudarib shall not guarantee the capital and/or profit.

14.2 Notwithstanding paragraph 14.1, the following measures may be exercised:

(a) The rabbul mal may take collateral from the mudarib, provided that the collateral could only be liquidated in the event of misconduct (ta'addi) or negligence (taqsir) or breach of terms (mukhalafah al-shurut) of contract by the mudarib; or

(b) The rabbul mal may require the mudarib to arrange for an independent third party guarantee by observing the following requirements:

(a) The guarantee shall be executed as a separate contract and be utilised to cover for any loss or depletion of capital.

(b) The third party guarantor shall be independent from the mudarib such that it shall not be a related party where the mudarib has majority ownership and/or having control in the entity nor shall it be an entity that owns or having controls over the mudarib.

(c) The third party guarantee may be in the form of performance guarantee of the mudarabah transactions or guarantee on mudarabah capital.

Footnote 34:

Shariah Resolutions in Islamic Finance, 2010 (Resolution No. 66 Application of Wakalah bi al-Istithmar in Deposit Product)

"An Islamic financial institution would like to introduce a deposit product based on wakalah bi al-istithmar (investment agency). Under this product, a customer will deposit a certain amount of money at the Islamic financial institution with the condition that such deposit shall only be invested in an instrument with the potential to generate return at a certain minimum rate (for instance 5% per annum). The Islamic financial institution will act as an agent in investing the customer's deposit and will be entitled to a fee as agreed by both parties.

However, the Islamic financial institution will not guarantee that the customer will be getting at least the minimum investment profit rate as expected. Any loss will solely be borne by the customer unless it is proven that the Islamic financial institution had been negligent or had breached the terms of agreement by investing in an instrument which has no potential to generate the minimum profit of 5% per annum. In addition, if the customer decides to terminate the investment contract earlier and withdraw all of his deposit, he is only entitled to receive the current value of the investment.

In this regard, the SAC was referred to on the issue as to whether the proposed deposit product which is based on wakalah bi al-istithmar is permissible.

Resolution

The SAC, in its 2nd special meeting dated 18 June 2007, has resolved that the proposed deposit account which is based on wakalah bi al-istithmar contract is permissible, subject to the following conditions:

i. If the Islamic financial institution has breached any terms of agreement or has negligently invested in an instrument which has no potential to generate profit at the minimum rate (for example 5% per annum), the Islamic financial institution will have to pay compensation as much as the principal sum of investment plus the actual profit (if any); and

ii. If the Islamic financial institution invested in an instrument that is expected to generate profit at the rate of at least 5% per annum but failed to reach the targeted rate due to problems which are not attributable to the negligent conduct of the Islamic financial institution, such loss shall be borne fully by the customer.

Basis of the Ruling

Principles of wakalah bi al-istithmar are identical to principles of mudarabah because the agent receives the deposit money from the customer for the purpose of investment. However, wakalah is based on ujah or commission. The application of wakalah principles in this form is not contrary to the objectives of Shariah as long as the original features of wakalah are being preserved. This is in line with the permissibility of wakalah as stated in al-Quran:

"...let one of you go to the city with this silver coin and find food that is purest and lawful (that is sold there). Let him bring you provision from it..."

The permissibility of wakalah has also been mentioned by Rasulullah SAW as in the following hadith:

"From 'Uqbah ibn 'Amir told that Rasulullah SAW gave him a few goats to be distributed amongst his companions and one male goat was left after the distribution. He informed Rasulullah SAW about it, and then he said: Slaughter it on my behalf."

"(Dealing of) Muslims is based on conditions (as agreed) amongst them, except conditions that permit a forbidden matter or forbid a permissible matter."

Based on these hadith, the customer is entitled to instruct the Islamic financial institution who acts as his agent, to invest in a particular instrument that potentially generate a minimum profit. Therefore, if the customer decides to terminate the investment contract and withdraw all the deposited amount, the customer is deemed as withdrawing the mandate to manage capital from the Islamic financial institution. In this situation, the customer will only be entitled to the current investment value. This is viewed to be consistent with the consensual views of all four schools relating to investment contracts such as mudarabah, whereby all schools agree that a mudarabah contract is annulled or terminated by an expressed statement of termination, or by the conduct of the capital provider in withdrawing the mandate to manage the capital."

Footnote 35:

AAOIFI Shari'ah Standard No.5 on Guarantees (Article 2/2):

"It is not permissible to stipulate in trust contracts, e.g. agency contracts or contracts of deposits, that a personal guarantee or a pledge of security be produced, because such a stipulation is against the nature of trust contracts, unless such a stipulation is intended to cover cases of misconduct, negligence or breach of contract. The prohibition against seeking a guarantee in trust contracts is more stringent in musharaka and mudarabah contracts, since it is not permitted to require from a manager in the mudarabah or musharaka contract or an investment agent or one of the partners in this contracts to guarantee the capital, or to promise a guaranteed profit. Moreover, it is not permissible for these contracts to be marketed or operated as a guaranteed investment."

"It is not permissible to combine agency and personal guarantee on one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand), because such a combination conflicts with the nature of these contracts. In addition, a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest based loan, since the capital of the investment is guaranteed in addition to the proceeds of the investment, (i.e. as though the investment agent had taken a loan and repaid it with an additional sum which is tantamount to riba). But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to his principles independently of the agency contract, the agent becomes a guarantor in a different capacity from that of agent. In this case, such an agent will remain liable as guarantor even if he is discharged from acting as agent."

Footnote 36:

AAOIFI Shariah Standard No.23 on Agency and the Act of an Uncommissioned Agent (Article 5/2):

"The agent is considered as a trustee in holding the asset in question, and therefore, he is not bounded to indemnify the principal for that asset in case of damage. He shall be held responsible for indemnity only when the damage results from his own misconduct, negligence or breach of terms or stipulations of the contract. In this regard, Shari'ah Standard No. 5 on Guarantees indicates under item 2/2 the following:

"It is not permissible to combine agency and personal guarantee on one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand), because such a combination conflicts with the nature of these contracts. In addition, a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest based loan, since the capital of the investment is guaranteed in addition to the proceeds of the investment, (i.e. as though the investment agent had taken a loan and repaid it with an additional sum which is tantamount to riba). But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to his principles independently of the agency contract, the agent becomes a guarantor in a different capacity from that of agent. In this case, such an agent will remain liable as guarantor even if he is discharged from acting as agent."

Footnote 37:

AAOIFI Shari'ah Standard No.5 on Guarantees (Article 7/6):

"It is permissible for a third party, other than the mudarib or investment agent or one of the partners, to undertake voluntarily that he will compensate the investment losses of the party to whom the undertaking is given, provided this guarantee is not linked in any manner to the mudarabah financing contract or investment agency contract."

Footnote 38:

Shariah Resolutions in Islamic Finance, 2010 (Resolution No. 66 Application of Wakalah bi al-Istithmar in Deposit Product)

"An Islamic financial institution would like to introduce a deposit product based on wakalah bi al-istithmar (investment agency). Under this product, a customer will deposit a certain amount of money at the Islamic financial institution with the condition that such deposit shall only be invested in an instrument with the potential to generate return at a certain minimum rate (for instance 5% per annum). The Islamic financial institution will act as an agent in investing the customer's deposit and will be entitled to a fee as agreed by both parties.

However, the Islamic financial institution will not guarantee that the customer will be getting at least the minimum investment profit rate as expected. Any loss

will solely be borne by the customer unless it is proven that the Islamic financial institution had been negligent or had breached the terms of agreement by investing in an instrument which has no potential to generate the minimum profit of 5% per annum. In addition, if the customer decides to terminate the investment contract earlier and withdraw all of his deposit, he is only entitled to receive the current value of the investment.

In this regard, the SAC was referred to on the issue as to whether the proposed deposit product which is based on wakalah bi al-istithmar is permissible.

Resolution

The SAC, in its 2nd special meeting dated 18 June 2007, has resolved that the proposed deposit account which is based on wakalah bi al-istithmar contract is permissible, subject to the following conditions:

i. If the Islamic financial institution has breached any terms of agreement or has negligently invested in an instrument which has no potential to generate profit at the minimum rate (for example 5% per annum), the Islamic financial institution will have to pay compensation as much as the principal sum of investment plus the actual profit (if any); and

ii. If the Islamic financial institution invested in an instrument that is expected to generate profit at the rate of at least 5% per annum but failed to reach the targeted rate due to problems which are not attributable to the negligent conduct of the Islamic financial institution, such loss shall be borne fully by the customer.

Basis of the Ruling

Principles of wakalah bi al-istithmar are identical to principles of mudarabah because the agent receives the deposit money from the customer for the purpose of investment. However, wakalah is based on ujah or commission. The application of wakalah principles in this form is not contrary to the objectives of Shariah as long as the original features of wakalah are being preserved. This is in line with the permissibility of wakalah as stated in al-Quran:

"...let one of you go to the city with this silver coin and find food that is purest and lawful (that is sold there). Let him bring you provision from it..."

The permissibility of wakalah has also been mentioned by Rasulullah SAW as in the following hadith:

"From 'Uqbah ibn 'Amir told that Rasulullah SAW gave him a few goats to be distributed amongst his companions and one male goat was left after the distribution. He informed Rasulullah SAW about it, and then he said: Slaughter it on my behalf."

"(Dealing of) Muslims is based on conditions (as agreed) amongst them, except conditions that permit a forbidden matter or forbid a permissible matter."

Based on these hadith, the customer is entitled to instruct the Islamic financial institution who acts as his agent, to invest in a particular instrument that potentially generate a minimum profit. Therefore, if the customer decides to

terminate the investment contract and withdraw all the deposited amount, the customer is deemed as withdrawing the mandate to manage capital from the Islamic financial institution. In this situation, the customer will only be entitled to the current investment value. This is viewed to be consistent with the consensual views of all four schools relating to investment contracts such as mudarabah, whereby all schools agree that a mudarabah contract is annulled or terminated by an expressed statement of termination, or by the conduct of the capital provider in withdrawing the mandate to manage the capital."

Footnote 39:

Shariah Resolutions in Islamic Finance, 2010 (Resolution No.105 Scope of Danajamin's Guarantee on Sukuk).

"The SAC was referred to ascertain the scope of guarantee by Danajamin on the sukuk issuer, specifically on the issue as to whether Danajamin may guarantee capital and profit value.

Resolution

The SAC, in its 10th special meeting dated 9 April 2009, has resolved that:

- i. For sale-based sukuk like murabahah, Danajamin shall guarantee both capital and profit value; and*
- ii. For sukuk issued based on isytirak contract (partnership) like musyarakah, mudarabah and wakalah bi al-istithmar, Danajamin shall guarantee the capital value only.*

Basis of the Ruling

For sukuk issued based on isytirak contract like musyarakah, mudarabah and wakalah bi al-istithmar, Danajamin as a third party may only guarantee the amount of capital. This is in line with the jurists' view that third party guarantee is permissible for musyarakah, mudarabah and wakalah bi al-istithmar contracts but the guarantee is restricted only to the capital value."

Footnote 40:

Shariah Standard on Mudarabah

14.1 Mudarib shall not guarantee the capital and/or profit.

14.2 Notwithstanding paragraph 14.1, the following measures may be exercised:

(a) The rabbul mal may take collateral from the mudarib, provided that the collateral could only be liquidated in the event of misconduct (ta'addi) or negligence (taqsir) or breach of terms (mukhalafah al-shurut) of contract by the mudarib; or

(b) The rabbul mal may require the mudarib to arrange for an independent third party guarantee by observing the following requirements:

- (a) *The guarantee shall be executed as a separate contract and be utilised to cover for any loss or depletion of capital.*
- (b) *The third party guarantor shall be independent from the mudarib such that it shall not be a related party where the mudarib has majority ownership and/or having control in the entity nor shall it be an entity that owns or having controls over the mudarib.*
- (c) *The third party guarantee may be in the form of performance guarantee of the mudarabah transactions or guarantee on mudarabah capital.*

Footnote 41:

"Kafalah on Mudharabah Capital" published by Malaysia International Financial Centre (MIFC) at http://www.mifc.com/index.php?ch=menu_know_ftw&pg=menu_know_ftw_reso&ac=526&mode=view

The Original Law on Guarantees for Mudharabah Capital

According to the arguments of past Islamic jurisprudence, the jurists were unanimous in their opinion that when losses occur in a mudharabah contract, the loss is to be borne by the rabb mal and not the mudharib as the latter's status is only amin (trustee). However, if it could be proven that the loss was clearly due to the mudharib's negligence or intentional, then the mudharib is to make good the capital to the investor.

Past Islamic jurists were unanimously of the opinion that in a situation where a loss occurs on a mudharabah, a capital guarantee by the mudharib is not permissible. However, they have different opinions on the status of the contract. The Hanafi and Hanbali Mazhab were of the opinion that the contract is valid and the conditional guarantee should be nullified. The Maliki and Syafi'i Mazhab, however, were of the opinion that the mudharabah contract is immediately nullified if there is such a guarantee.

Contemporary Islamic jurists have made studies on the acceptable level of capital in mudharabah contracts that can be guaranteed according to the perspective of Islamic jurisprudence. The main issue of concern in relation to capital guarantee is whether the guarantee given will cause the mudharabah contract to be nullified since it violates the muqtadha 'aqd (the main objective of a contract).

They have submitted several solutions on mudharabah capital guarantee, including:

- (a) *Third-party guarantee based on tabarru' (voluntarily given);*
- (b) *Third-party guarantee based on qardh (debts);*
- (c) *Mudharib yudharib (the entrepreneur channels the investor's capital to investing in a third party); and*
- (d) *Guarantee through special funds.*

Third-Party Guarantee Based on Tabarru'

The OIC Fiqh Academy discussed on the matter of issuance of sanadat muqaradhah and summarised that mudharib guarantee on capital and mudharabah profits are not permissible. However, the guarantee may be issued by a third party who has no connection whatsoever with the mudharib if it is done by way of tabarru' and is not included as a condition in the actual mudharabah contract sealed and signed by both parties.

The Shariah Council for Accounting and Auditing Organization for Islamic Institutions (AAOIFI) allowed for third-party guarantees other than by mudharib or investment agent or business partner towards the liability of investment losses. However, this is on the provision that the guarantee given is not tied to the original mudharabah contract. The basis of their decision is tabarru' which is allowed by Shariah.

Husain Hamid Hassan summarised the basis of the permissibility of third-party guarantees based on the views of the Maliki Mazhab which allow wa'd mulzim (promises that must be kept). It is further strengthened by maqasid Shariah (Shariah's objective) which allows for such action.

Third-Party Guarantee Based on Qardh

The OIC Fiqh Academy, disagrees with the basis of third-party guarantees that are based on debt and resolved that third-party guarantees have to be in the form of tabarru'. Otherwise, the contract is deemed to be an interest-bearing debt which is not permissible.

Mudharib Yudharib

Past Islamic jurists also delved on the issue of mudharabah capital guarantee in the context of mudharib yudharib. The mudharib invests the capital received from rabb mal to another party. In other words, the mudharib acts as an intermediary between the first rabb mal and the actual entrepreneur. Wahbah al-Zuhaili summed up the views of past Islamic jurists on the issue of mudharib yudharib that all the four fiqh sects collectively agreed that the first mudharib shall be responsible for the liability of the guarantee (dhaman) if the capital is invested or handed over to another mudharib (third party).

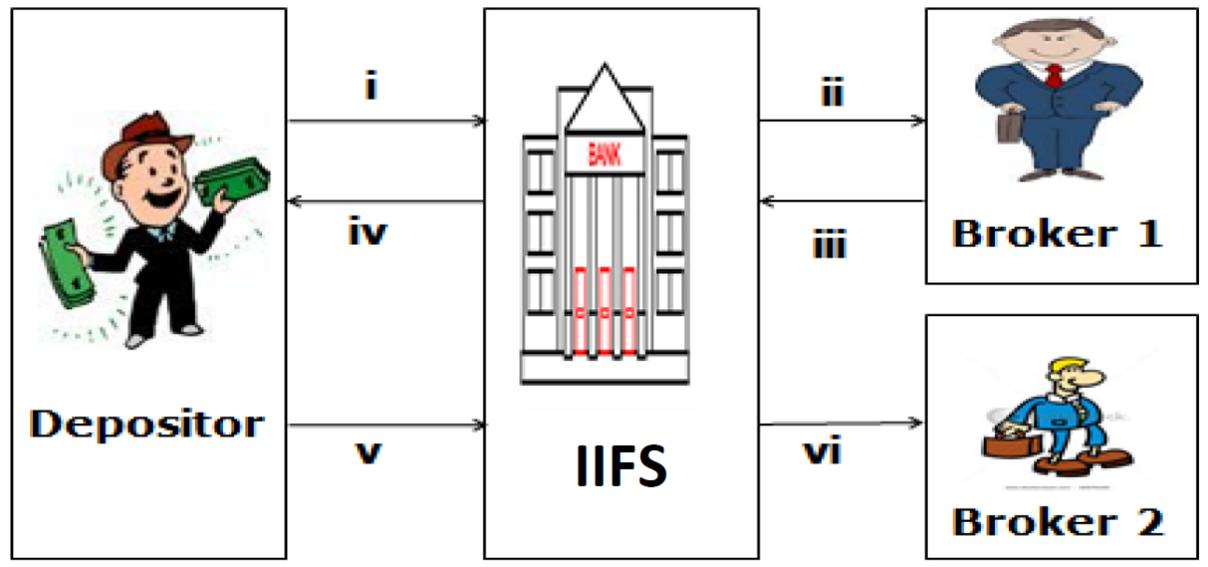
Generally, the mudharib yudharib concept is allowable. If it bears any profit, the profit should be distributed between the rabb mal and the first mudharib based on a pre-agreed rate and the balance is to be distributed between the first mudharib and the second mudharib.

For financial institutions and companies that issue financial products based on mudharabah, the concept of mudharib yudharib may be applied if they invest part of the capital in other parties. If this happens, the financial institutions or companies should guarantee the capital based on the views of majority of Islamic jurists. Hence, in such a situation the interest of investors is guaranteed.

Guarantee Through Special Funds

Contemporary Islamic jurists also allow the channeling of a portion of mudharabah profits to a special fund created for the purpose of insuring against future losses. This may be done with the concurrence of investors.”

APPENDIX II: Detailed Murabahah Transaction in Islamic Fixed Term Deposit



- i. The depositor appoints the IIFS as his agent to buy a commodity from Broker 1. The depositor then places his money (say USD 1,000) into the Islamic term deposit at the IIFS.
- ii. The IIFS uses the money (USD 1,000) deposited by the depositor to buy a commodity from Broker 1.
- iii. After Broker 1 accepts USD 1,000 from the IIFS, the commodity is delivered to the IIFS.
- iv. The IIFS delivers the commodity to the depositor.
- v. The depositor then sells the commodity to the IIFS on a deferred payment basis. The basis for the deferred payment price is the cost of the commodity plus a percentage of profit as agreed between the depositor and the IIFS (say USD 1,000 plus 20% profit margin. So the deferred selling price is USD 1,200). The IIFS is to settle the deferred payment price on the depositor within the term agreed between both parties (maturity term of the Islamic term deposit). So, at maturity of the deposit, the IIFS should have delivered USD 1,200 in total to the depositor.
- vi. Immediately after the depositor sells the commodity to the IIFS, the IIFS would sell the commodity to another party at USD 1,000, on a spot basis.

NOTE: The price of the commodity in the murabahah contract that takes place in point (v) is the amount that should be guaranteed by the IIFS. If the IIFS fails before the deposit matures, a deposit insurer may guarantee that the price of the commodity is delivered to the depositor.

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