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Justifications of avoiding Riba (Part IX): The case of bank runs

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In his last article, MABROOR MAHMOOD showed how Charles Ponzi could attract investors with ‘promised’ or ‘guaranteed’ returns without any real investments, and how the scheme eventually collapsed. In this article, he will illustrate how the behavior of the depositors are influenced by the ‘promised’ or ‘guaranteed’ returns on their monetary savings with the banks.

When a certain return on savings is guaranteed, it influences the minds of depositors with a sense of comfort that their savings will grow over time with a pre-determined rate.

If the prices of all goods and services are known and the rates of increase of such prices are forecasted accurately, depositors can easily calculate how much more goods and services they can buy in the future with the added returns they get from their savings with the banks.

Such a sense of comfort induces depositors to alter their savings and investment plan. They might be willing to spend more on luxurious goods and unproductive investments today just because they know for sure that they will have added income tomorrow.

But what happens if this calculation proves to be wrong? What happens if there is an economic crisis all of a sudden and depositors discover that they will have a mismatch of income and savings soon in the near future?

If such cases happen, then depositors panic because of the possibility of losing their savings that they kept with the bank, which is supposed to pay them a guaranteed return. But now with the crisis, they are not mentally ready to accept any loss on their savings because they were all driven by a sense of ‘guarantee’.

Such panic induces depositors to claim their deposits from the bank, and if this happens en masse, the bank itself might not be able to satisfy the demands of all depositors. This will result in bank failures, popularly known as a ‘bank run’.

A bank run occurs when the bank is unable to make enough money from its investments to satisfy depositors, and such failures are accelerated when this news is conveyed to depositors and they then want their money back en masse.

If one bank faces such a crisis, it might trigger the same crisis in other banks if the panic spreads quickly. When all depositors in the financial industry panic, it might cause a meltdown of the entire banking industry.

During the Great Depression of the 1930s, multiple banks in the US failed due to the panic of depositors. During that period, the state of banking panic started in Tennessee and Kentucky and eventually spread to New York City, Philadelphia, Boston and Chicago that caused multiple bank runs.

Now consider the following scenario between a bank and depositors:

Bank: *“Thank you, sir, for considering our bank to deposit your savings. As you know, we run under* Shariah *principles and we will invest your money in productive opportunities and at the end of the year, we will tell you how much profit or loss your savings will incur.”*

Depositors: “What does that mean? You are not giving me a specific rate of return on my savings?”

Bank: *“No sir. How do we know today how much money we will make from the investments with your savings?*

Depositors: “But why then are other banks offering me a guaranteed return on my savings?”

Bank: *“Well. Those banks don’t follow* Shariah *guidelines. If I give you a promised return, it means I am entering into a contract with you to exchange 100 dollars today with 110 dollars tomorrow, which is called* Riba *in Islam and is forbidden by God Almighty.”*

Depositors: “Ok. But what happens if you don’t make money on your investments?”

Bank: *“In that case sir, your savings will go down and loss will be shared with us.”*

Depositors: “What? My savings will go down if you make a loss?”

Bank: *“Unfortunately, yes sir.”*

Depositors: “Then why should I keep my savings with your stupid bank?”

Bank: *“Well sir, our record shows that from inception, we have been able to share profits with our depositors. When we incurred some losses, it was offset by profits that we made. So most of the time we could offer some positive returns to our depositors. That’s why people have confidence over us and they deposit their savings with us.”*

Depositors: “But things might turn around next year and I might incur a loss?”

Bank: *“Yes, sir. There is no guarantee that your savings will grow over time.”*

If the aforementioned scenario happens, then theoretically we can say that depositors will diversity their savings portfolio where besides investing their money with banks, they will also directly invest in businesses. They will also have a lower tendency to panic in case of an economic downturn because they are already mentally ready to suffer losses during a crisis.

So don’t you think that a Riba-free alternative is beneficial for the banking industry?

(To be continued)

The views expressed here are the author’s own and do not necessarily represent the views of the institution where he works.

*Mabroor Mahmood is the principal of term finance at the **Islamic Corporation for the Development of the Private Sector**. He can be contacted via email at mabroorm@isdb.org or via **Twitter** at @MabroorM.*