Religion, Deposit Insurance, and Deposit Market Outcomes: Evidence from Islamic Banks

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Account at a formal financial institution, World Bank 2020 Projection
World by religion, 2016
Motivation

Potential reasons for financial exclusion

- Regulations making financial inclusion costly (Beck et al., 2007)
- Travel distance (Beck et al., 2007)
- Legal hurdles or other financial frictions (Beck et al., 2007)
- Reluctance despite affordable financial inclusion (not explored so far)

My focus:

- Whether religious compliance of the financial system matters for depositors decision to supply deposits?
- Whether depositors of Islamic banks care about Sharia compliance?
Impossible to put banks into a lab environment, apply random treatment and establish causality!

Possible to find a natural experiment that mimics lab environment

An exogenous event that makes some Islamic banks more Shariah compliant than the others

Use affected ones as “treatment group” and unaffected ones as “control group”
Exogenous intervention: Separation announcement of deposit insurance funds
Islamic vs. conventional deposit insurance

- **Deposit Insurance Fund**: Public institutions that insure individual deposit accounts
- It ensures financial stability by preventing bank runs.
- In dual banking systems (Islamic and Conventional together), deposit insurance fund is administered with conventional rules - No Sharia compliance mechanism in place
- **Exogenous event**: Some jurisdictions separate deposit insurance funds to allow Islamic banks to have a fund administered by Sharia rules
## Treatment assignment

Table 1: **Treatment** (announcement of separate Islamic deposit insurance scheme)

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Result 1: Dynamic effects - deposit growth
Result 2: Incentive Incompatibility

- Under conventional coverage of Islamic deposits: Danger of being compensated by “impure” funds when an Islamic bank fails
- This gives depositors to monitor and discipline their banks (Market discipline)
- No incentives to monitor under Sharia compliance since no danger of being compensated with impure funds
- Depositors do not monitor and discipline their banks anymore.
- This leads to banks taking excessive risk
- Intervention is not incentive compatible!
Conclusion

- Effects of Sharia-compliant deposit insurance schemes on the deposit market.
- Increase in supply of deposits after the announcement of Sharia-compliant deposit insurance.
- Former market discipline vanishes - depositors’ incentives to monitor their banks vanish.
- Trade-off between availability of funds and market discipline.
Take-aways

- Islamic banking as an innovation bringing market-based solution to a social issue and profit at the same time
- However depositors’ incentives are not compatible with sustaining the market.
- Future efforts should focus on ensuring creating right incentives.

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- Code and “synthetic data” are available upon request!
- Contact me if you want to develop a joint project!