



Deposit Insurance from the Shariah Perspective

Discussion Paper

Prepared by the Islamic Deposit Insurance Group of the
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I. Executive Summary

Deposit insurance is relatively new to the Islamic financial world and it has attracted a lot of interest as regards understanding its permissibility from the Shariah (Islamic law) perspective, and the differences between Islamic or Shariah-compliant¹ and conventional deposit insurance systems. This paper discusses briefly the arguments put forward by deposit insurance practitioners as to why deposit insurance is permissible under Shariah, and the differences between Islamic and conventional deposit insurance systems. The paper does not provide any fatwa² on Islamic deposit insurance but rather presents some related Shariah views. The paper also discusses approaches in designing an Islamic deposit insurance system (IDIS), and describes the approaches taken by Malaysia and Sudan in developing their IDIS.

Limitation

The facts presented in this paper are limited to the extent of information available to the Islamic Deposit Insurance Group (IDIG), as information on global Islamic deposit insurance practices is not easily available. The information was obtained from several IADI member countries and its non-members through the Survey on Islamic Deposit Insurance (2009)³ and relevant materials. The IDIG shall not be responsible for any misrepresentation of facts in this paper.

¹ In this paper, the terms “Islamic” and “Shariah-compliant” carry the same meaning and therefore are used interchangeably.

² Fatwa means an opinion with religious approval in light of the Quran and Hadith.

³ The Survey on Islamic Deposit Insurance was conducted by the IDIG in 2009 and issued to selected IADI members and non-members. Among the objectives of the Survey were to identify countries that implement Islamic deposit insurance, obtain an overview of their current practices, and understand the issues and challenges facing them.

II. Introduction to Islamic Deposit Insurance

Islamic deposit insurance⁴ is an arrangement to protect insured depositors against the loss of their insured Islamic deposits⁵ placed with Islamic banking institutions (IBIs)⁶ in the event of an IBI's failure. It is implemented in countries where Islamic deposits are offered to the public.

Islamic deposit insurance has become more relevant of late due to the development of Islamic finance, which has grown rapidly not only in the Muslim world but also across the Western world. Today, the Islamic financial landscape has been dramatically transformed into a vibrant, dynamic and competitive global intermediation mechanism. The industry is supported by more than 300 Islamic financial institutions in over 75 countries, and its assets are projected to grow to USD 1.6 trillion globally by 2012.

The market for Islamic finance has the potential to grow further, given that the Muslim population accounts for almost one-fourth of the world population. According to a comprehensive demographic study of 232 countries, there are 1.57 billion Muslims of all ages living in the world today, representing 23% of an estimated 2009 world population of 6.8 billion.⁷

Additionally, many have started giving attention to Islamic finance as a potential alternative, following the global financial crisis that has seen the collapse of several giant conventional financial institutions. The Islamic financial system, which introduces greater discipline into the economy and links credit expansion to the growth of the real economy, is capable of minimizing the severity and frequency of financial crises.⁸

Despite the large number of countries adopting Islamic finance, only a few countries have introduced Islamic deposit insurance. This could be due to, among other things, the small size of Islamic deposits compared to total deposits in the overall financial system, or a lack of clarity as to the insurability of profit-sharing investment accounts (PSIAs; they tend to form the bulk of total Islamic funds). It thus makes sense that the global financial community is less aware of the existence of Islamic deposit insurance, and has yet to be convinced that it could contribute to overall financial system stability. Nevertheless, this phenomenon is expected to be revolutionized when the Islamic financial system becomes more significant in terms of its size.

⁴ Deposit insurance, protection and guarantee are generally similar.

⁵ Islamic deposits may include the profit-sharing investment account (PSIA). The PSIA is a placement based on profit-sharing; its mechanism is explained in the section on "Permissibility of Deposit Insurance from the Shariah Perspective".

⁶ IBIs comprise fully fledged Islamic banks and Islamic banking windows (a unit in conventional banking institutions that offers Islamic banking products and services).

⁷ Pew Forum on Religion and Public Life, October 2009.

⁸ Umer Chapra, 2008.

III. Development of Islamic Deposit Insurance around the World

The history of Islamic deposit insurance reportedly began a little over half a century after the world's first conventional deposit insurance system was established in the United States in 1933. Bahrain introduced an ex post⁹ IDIS in 1993 and to date, it remains the only country to have implemented such a system.

The first ex ante¹⁰ IDIS was established by Sudan in 1996. Sudan's IDIS is a fully fledged Islamic system, by virtue of the fact that its financial system is also fully Islamic. The IDIS is administered by the Bank Deposit Security Fund (BDSF), which was given the mandate to protect Islamic deposits pursuant to the Bank Deposit Security Fund Act 1996.

In 2001, Turkey developed an IDIS that operated alongside the conventional system – the first country to establish a dual deposit insurance system. Unlike the conventional system, which was administered by the government, the IDIS was administered by Participation Banks of Turkey to protect Islamic deposits in participation banks (financial institutions offering Islamic products). However, this model was revised in 2005, when the Islamic system was absorbed by the conventional system, and it is now administered by the Savings Deposit Insurance Fund (SDIF).

Malaysia set up its IDIS only 22 years after the establishment of its first Islamic bank. In 2005, Malaysia developed both Islamic and conventional deposit insurance systems, which operate in parallel but separately from each other. The IDIS aims at protecting Islamic deposits in fully fledged Islamic banks and Islamic banking windows. Following the dissolution of the IDIS in Turkey, Malaysia is now the only country in the world to implement a dual deposit insurance system. Both systems are administered under one roof by the Malaysia Deposit Insurance Corporation, which was given the mandate pursuant to the Malaysia Deposit Insurance Corporation Act 2005.

Also in 2005, Indonesia introduced protection for Islamic deposits under the Indonesia Deposit Insurance Corporation Act 2004. Similar to Turkey, Islamic and conventional deposits in Indonesia are protected under a conventional deposit insurance system, which is administered by the Indonesia Deposit Insurance Corporation (IDIC). The first Islamic bank in Indonesia was established in 1991, and at the end of 2008 the share of Islamic banking in term of assets was 2.2% of total assets in the banking industry.

⁹ "Ex post deposit insurance system" refers to a system in which a levy is imposed after the failure of an insured bank to provide funds to cover deposit insurance claims.

¹⁰ "Ex ante deposit insurance system" refers to a system in which a fund is accumulated to cover deposit insurance claims in anticipation of the failure of an insured bank. Most countries with deposit insurance systems use an ex ante system.

The developments described above in Islamic deposit insurance in the four countries reveal different models of Islamic deposit insurance. Further details of the implementation of Islamic deposit insurance in the four countries can be found in the Appendix. In summary, there are broadly three models of Islamic deposit insurance as follows:

- (1) Protect Islamic deposits under a conventional deposit insurance system;
- (2) Develop an IDIS separately from a conventional system; or
- (3) Develop a fully fledged IDIS.

Other countries that also provide protection for Islamic deposits include Bosnia and Herzegovina, Jordan, Kuwait, Singapore and the United Kingdom. These countries (except Jordan¹¹) use the model that protects Islamic deposits under the country's conventional deposit insurance system.

Some countries have made plans to provide protection for Islamic deposits but information on their proposed models is not yet available. Among the countries reported to be planning such protection are Brunei, Djibouti, Kazakhstan, Kenya, Nigeria, Pakistan, Palestine, Qatar and Syria.

The implementation of Islamic deposit insurance depends on how the government in the respective country views the permissibility of deposit insurance from the Shariah perspective. In this respect, Shariah authorities play an important role in determining the design or approach adopted in setting up Islamic deposit insurance. The following section will discuss the views of Islamic deposit insurance practitioners on the permissibility of deposit insurance from the Shariah perspective.

IV. Permissibility of Deposit Insurance from the Shariah Perspective

In the history of Islam, it was not the intention of the Prophet to rigidly fix the structure of conduct and action for all time, regardless of any change in circumstances. Instead, the Prophet only provided his Companions with general guidelines and allowed them to adjust to varied circumstances. The basis of reference has always been the consideration of the public interest (*maslahah*).

Maslahah, which is an Arabic word, means utility, good, beneficial or advantage, i.e. something good for the public. It relates to the preservation of faith, life, lineage, intellect and property of human beings.

¹¹ In Jordan, the deposit insurance membership is voluntary for Islamic banks operating in the Kingdom, but none of them has joined the system yet.

Deposit insurance contains the element of public interest, and therefore is permissible under Shariah. This element can be seen in several ways, which could also justify the need for deposit insurance.

First, deposit insurance protects the public from losing money that they place in a bank when the bank fails. Its implementation is a noble initiative as it prevents the public from facing financial difficulties, especially those people who have limited financial resources, who could be exposed to social problems as a result. Islam urges its followers to avoid poverty as this could lead them to disobey Allah.

Islam always wishes every creature to have a good and convenient life without having to face any difficulty. It also urges its followers to prepare themselves to face any possible disasters, which includes finding a means to protect their wealth. As such, the setting-up of a deposit insurance system represents the Muslims' response to the urge to protect their money when a bank fails.

Muslims are also urged to help each other in good deeds. In line with this principle, the government introduced deposit insurance as an initiative to assist the public in protecting their wealth. Such arrangements may also be made privately with the same intention of helping the public.

Second, deposit insurance can instill confidence among the general public as regards the safety of their bank deposits. This reduces the likelihood of panic among depositors in the event of a rumored or real bank failure. The effectiveness of deposit insurance in instilling public confidence is evidenced by the establishment of Federal Deposit Insurance Corporation (FDIC) in 1933 as this, to a great extent, helped reassure the American public about the safety of their bank deposits during the Great Depression. This in turn contributed to the recovery of the US financial system.

Undoubtedly, the financial system is the backbone of a country's economy. For example, banks make funds available for companies to set up or grow their businesses, which creates employment and contributes to the wealth of the nation. By instilling public confidence, deposit insurance could prevent the failure of a bank and contagion to the entire financial and economic system, thereby contributing to financial stability. Islamic deposit insurance could contribute in the same way, especially when the Islamic financial system is significant in size and has integrated well with the overall financial system.

Islamic deposit insurance protects Islamic deposits, and therefore helps maintain the competitiveness of Islamic deposits vis-à-vis conventional deposits. It can thus prevent any outflow of Islamic deposits from IBIs to conventional banks and help spur the growth of Islamic deposits and the Islamic financial system.

While deposit insurance is expected to serve the above public interests, the government should ensure that the system design works effectively and mitigates moral hazard.

However, there is another factor that could influence the permissibility of deposit insurance: the insurability of Islamic deposits. Islamic deposits are accepted by IBIs based on Shariah principles. They are offered under various Shariah contracts such as safe-keeping (*wadiah*), loan (*qard*), cost-plus (*murabahah*) and profit-sharing (*mudharabah*). With the exception of the profit-sharing contract, none of these contract types has given rise to concerns over the protection of deposits.

The deposits accepted under a profit-sharing contract (known as a profit-sharing investment account or PSIA) are *mudharabah* placements made by an investor (PSIA holder) with an IBI, which acts as entrepreneur. The IBI will invest the fund for Shariah-compliant business activities, such as the provision of financing and investment in *Sukuk*. Any profit from such activities will be shared between the PSIA holder and the IBI according to an agreed profit-sharing ratio. Any losses are borne by the PSIA holder, except in the case of the IBI's mismanagement or negligence, where losses are borne by the IBI.

Since losses are borne by the PSIA holders, some have argued that PSIA holders should not enjoy protection. On the other hand, some are of the view that PSIA holders should be protected, by virtue of the following:

- (1) The profit-sharing contract does not allow the IBI to protect the PSIA holder, but protection by third party (e.g. the deposit insurer) is allowable;
- (2) The PSIA holder is only protected in the event of an IBI's failure and not in the normal course of business; and
- (3) If the PSIA holder is a major player in the financial system, protection will contribute to the stability of the financial system.

There are two categories of PSIA: restricted and unrestricted. Some countries may not protect holders of the former, as they are regarded as investors (rather than depositors) who understand well the risk/reward relationship of their placement or investment. This is purported to exert market discipline among the restricted PSIA holders when placing or investing their money. By contrast, holders of unrestricted PSIA may be protected as they behave like depositors (rather than investors). The question of whether the PSIA should be treated as a deposit or an investment, and whether PSIA holders should be protected under deposit insurance, continues to be a subject for debate among the Islamic financial community.

V. Need for an IDIS

We have discussed the potential for deposit insurance to prevent the public from experiencing financial difficulties, instill public confidence about the safety of deposits, promote financial system stability, and maintain the competitiveness of Islamic deposits. Given that these aims could be served by a conventional deposit insurance system, why do countries offering Islamic finance (with the exception of Sudan) need to establish a separate IDIS?

It is true that the above aims could be served by a conventional deposit insurance system. Nevertheless, an IDIS may be needed for other reasons.

First, the Muslim community aspires to a deposit insurance system that meets Shariah requirements and is in line with their way of life. In this regard, the system must be free from the elements that Islam strictly prohibits, such as interest, uncertainty and gambling (these elements are discussed in further detail in the next section). This argument is more relevant in Muslim countries, where the Muslim community is in the majority and they demand a comprehensive Islamic financial system covering Islamic banking and Islamic deposit insurance.

Second, establishing an IDIS could be advantageous for a country that has developed an Islamic financial system. A comprehensive safety net contributes to the stability of the financial system, and this attracts foreign investors seeking Islamic ways of investing and protecting their funds.

Third, the conventional deposit insurance system may not be able to deal with the unique feature of Islamic deposits, in particular the PSIA.

VI. Shariah Requirements for an IDIS

The basic principle of all Islamic financial transactions is that they must be free from elements that Islam strictly prohibits, i.e. interest (*riba*), uncertainty (*gharar*), and gambling (*maisir*). These prohibited elements are clearly stated in the Holy Quran.¹² This section attempts to discuss their existence in a deposit insurance system context.

¹² This paper does not intend to present a detailed discussion of these forbidden elements, which can be found in many literature sources on Islamic finance.

Interest

In any financial transaction, interest or usury exists when there is an unequal exchange of two interest-based or usurious commodities¹³ or an exchange of money for money with different quantities, different values and at different times.

When discussing the existence of interest in deposit insurance, the exchange of two interest-based commodities is irrelevant as deposit insurance does not involve commodities. However, a discussion is appropriate in the context of the exchange of money for money, i.e. whether the act is embedded in deposit insurance.

To illustrate the interest element in the context of an exchange of money for money, let us consider an example in which one party gives money to another and the former receives an amount which is different from the amount he gave out. In finance, the interest element exists in a transaction, for instance, when a bank lends USD 1 million to a borrower and receives a payment of USD 1.5 million from the borrower. In another example, a depositor makes a placement of USD 1,500 in a bank and receives USD 1,550 from the bank upon maturity of the placement.

Based on the above examples, interest obviously gives an advantage to people with a surplus of money, who receive a premium on their money lent out to people faced with a deficit of money. However, Islam urges its followers to do away with interest as there is injustice¹⁴ inflicted on the interest payers.

Under the ex-ante deposit insurance system, a bank pays premium to the deposit insurer and, if the bank is wound up, the deposit insurer will reimburse the insured depositors. Are the acts of the deposit insurer in collecting the premium from the bank and reimbursing the insured depositors of the bank, deemed to be an interest-based transaction?

Based on the above, deposit insurance does involve the exchange of money for money and the exchange occurs with different values and at different times. Hence, some Shariah scholars would argue that it is an interest-based transaction and therefore non-permissible.

The interest element could also exist in deposit insurance when the deposit insurer is involved in interest-based transactions or activities. This can happen when the deposit insurer protects deposits, invests the deposit insurance funds, lends to troubled banks, and obtains external funds (when in deficit), in which all these activities are based on interest.

¹³ Interest-based (*ribawi*) commodities include gold, silver, wheat, barley, dates, and salt.

¹⁴ This paper does not intend to discuss in detail the injustice inflicted by interest, as this is addressed in many literature sources on the prohibition of interest in Islam.

Uncertainty

Uncertainty exists when either the object or the subject matter of a transaction or activity is uncertain. It can occur either naturally or through a deliberate act by parties involved in the contract.

All transactions and activities including deposit insurance may contain the element of uncertainty. Shariah scholars distinguish two categories of uncertainty: permitted and prohibited under Shariah. Shariah prohibits uncertainty when, for example, its existence is excessive, which could lead to undue losses for one party or disagreement between the transacting parties.

The uncertainty element exists in deposit insurance in respect of the failure of a bank. Nevertheless, such uncertainty may not be prohibited as it is unavoidable and naturally embedded in deposit insurance. The setting-up of a deposit insurance system is in line with the government's strategy that it must always be ready to face the failure of a bank and to protect insured depositors. According to another argument, such uncertainty is not prohibited as it does not provide an avenue for one party to gain while another will suffer loss.

There is no issue of uncertainty in deposit insurance with regard to, for example, the deposit products covered, the amount to be reimbursed to insured depositors, and when they would be reimbursed, as an explicit deposit insurance system would address these through government regulation.

Gambling

Gambling arises from uncertainty when there is a chance that one party will suffer a loss while another will make a profit from an event. As discussed above, the only uncertainty in deposit insurance is the event of a bank's failure but this is unavoidable and embedded in deposit insurance. Furthermore, no party will gain in the event that a bank fails. Therefore, the gambling element is irrelevant in deposit insurance.

Other Shariah Requirements

In addition to interest, uncertainty and gambling, Shariah also does not allow certain other elements to exist in a deposit insurance system. For instance, the deposit insurance fund must not be used for the purchase of liquor and pork, or for any activities that are prohibited under Shariah.

In addressing the prohibited elements in a financial transaction, Islam provides the approaches such as the application of Islamic contracts. The guarantee (*kafalah*) and donation (*tabarru*) contracts for instance may

eliminate the interest element in deposit insurance. While the application of Islamic contracts could be the recommended approach, it could pose a challenge to the deposit insurer in meeting the requirements of the contracts. As such, in the absence of suitable contracts to govern the operations of deposit insurance, the system may be implemented on the basis of *siasah syar'iyah*, which is a government initiative for public's interest. These are discussed in the section on "Approaches in Designing an IDIS" of the paper. The government should also have policies in place to ensure that Islamic deposit insurance operations are in line with Shariah principles.

VII. Differences between Islamic and Conventional Deposit Insurance Systems

As mentioned earlier, the mechanisms of Islamic and conventional deposit insurance systems are generally similar, in that the deposit insurer collects premiums from banks and protects the insured depositors of a failed bank. However, the IDIS is subject to the above Shariah requirements, and thus its operations may differ from the conventional system, as depicted in the following table:

Table 1: The differences between Islamic and conventional deposit insurance systems

No.	Subject	Islamic deposit insurance system	Conventional deposit insurance system
1	Instruments covered	Islamic deposits (this may include PSIAs)	Interest-based deposits
2	Institutions covered	IBIs, i.e. Islamic banks and Islamic banking windows	Conventional banks
3	Premium payments	From the IBI's own funds. If the PSIA is protected, premiums may also be paid from returns on the PSIA's investments	From the conventional bank's own funds
4	Differential premium system	Key financial indicators for assessing risk profiles of IBIs (especially unique risks)	Key financial indicators for assessing risk profiles of conventional banks

5	Funds	Premiums received from IBIs maintained in Islamic deposit insurance fund (separate book if dual operation, and no commingling/cross-subsidization)	Premiums received from conventional banks maintained in conventional deposit insurance fund
6	Expenses	Incurred for permissible activities only	Incurred for any activities
7	Investment	Investment in permissible business activities and instruments only	Investment in any business activity or instrument
8	Payments	Made from Islamic fund	Made from conventional fund
9	Priority of payments within deposit category	Payments for deposits and PSIA's are prioritized based on underlying contracts	There is no priority of payment for deposits
10	External funding (in case of deficit)	From the Government or market based on Shariah principles	From the Government or market
11	Liquidation	Assets funded by restricted PSIA's may be liquidated separately	Not applicable since there is no PSIA

Table 1 shows an idealized IDIS operation. However, some countries may face challenges in implementing some aspects, due to the respective country's specific limitations. For instance, a country with minimal Islamic finance business may provide protection for Islamic deposits under its conventional system for better administration. However, the permissibility of such operations is subject to Shariah views.

VIII. Approaches in Designing an IDIS

As discussed in the earlier section on “Shariah Requirements for an IDIS”, there are several approaches that a government could adopt in designing a Shariah-compliant deposit insurance system. These approaches include:

- (a) Government regulation;
- (b) Adoption of a Shariah-based contract (hereafter: “contract”); and
- (c) A combination of contract and government regulation.

The permissibility of these approaches is, however, subject to interpretation by Shariah authorities in the respective jurisdictions.

Government Regulation

In Islam, a government initiative to set up deposit insurance is in line with the Islamic concept of *siasah syar’iyyah*, which means any action taken by the government in the public interest (*maslahah*), although it is not prescribed by the Quran or the Prophet.

Under this approach, the government, in the absence of a Shariah-compliant approach, implements the deposit insurance system by giving priority to the socio-economic benefits of the system over the way it is conducted. Such a view is strengthened by the fact that there is hardly any alternative to deposit insurance as a means to satisfy the legitimate need for deposit protection. In this regard, the government regulation approach tolerates the existence of any forbidden elements that are inherent in the deposit insurance mechanism.

Why are other approaches needed if the government can impose its regulation in implementing deposit insurance? Other approaches are used where the government, in consultation with Shariah scholars, believes that the public interest argument alone is insufficient to justify a Shariah-compliant deposit insurance system.

Adoption of Contract

A contract is the best available means, be it in Islamic or conventional legal systems, to reflect the intention and consent of contracting parties. In the Quran, there are over 40 verses on several types of commercial contracts.

Among the contracts that have been applied to Islamic financing and deposit products are loan (*qard*), cost-plus (*murabahah*), profit-sharing (*mudharabah*), profit- and loss-sharing (*musyarakah*), leasing (*ijarah*), safe

custody (*wadiyah*) and agency (*wakalah*). For an IDIS, applicable contracts include "guarantee with fee" (*kafalah bil ujr*) and "donation" (*tabarru*).

The contract of guarantee with fee is a contractual guarantee given by a guarantor to assume the responsibilities and obligations of the party being guaranteed should claims arise. As consideration for the guarantee, a fee is paid by the guaranteed party to the guarantor.

Under an IDIS, the deposit insurer uses this contract to create a relationship between an IBI, as guaranteed party, and the deposit insurer, as guarantor. As consideration for the guarantee, the IBI pays a fee to the deposit insurer in the form of annual premiums and, in the event that the IBI fails, the deposit insurer will assume the obligation of reimbursing insured depositors.

There is an ongoing debate about the adoption of the guarantee contract in any financial transaction, owing to the existence of the fee element in the contract. On the one hand, a number of classical Shariah scholars are of the view that charging a fee for a guarantee is not allowed, based on the argument that the contract is voluntary in nature. On the other hand, some Shariah scholars recognize the need to allow it, based on the current needs of the community.

Receiving a premium as the fee in deposit insurance is indeed necessary, as it is used to fund the operations of the IDIS. Besides reimbursing insured depositors in the event of a failure, the fund is also needed to cover the deposit insurer's operating and development costs.

Another justification of the need to collect premiums is that it is not feasible to develop an IDIS that is solely financed by the government or by private funds. Deposit protection through blanket guarantee could be costly to the government, which in turn would place a direct or indirect financial burden on the public.

Donation (*tabarru*) is defined as the voluntary transfer of ownership of an asset or its usufruct from one party to another without stipulating any countervalue. Under an IDIS that operates based on the donation contract, an IBI agrees to pay premiums in the form of donations or voluntary contributions to a fund (deposit insurance fund). The deposit insurer, acting as manager of the fund, will use the fund to reimburse depositors of any IBI that suffers a failure. This contract is suitable for a deposit insurance system in which membership is not mandatory.

The deposit insurer may also attach the element of mutual cooperation (*ta'awuni*) to the donation contract to form a new contract called *tabarru' ta'awuni*. Under such a contract, all IBIs in the system agree to make voluntary contributions (in the form of premiums) to protect depositors of any IBI that suffers a failure. Given that *tabarru'* and *ta'awuni* are the main

features of *takaful*, the deposit insurance system operating under such a contract may be referred to as "deposit *takaful*".

In addition to the guarantee with fee and donation contracts, there are other contracts available which could be examined and assessed on their applicability to an IDIS. It is important to note that different contracts come with different conditions or requirements, and thus it is possible to create deposit insurance schemes with different designs or features. The main challenge of adopting the contract approach lies in the government's ability to match its intended or existing IDIS design with the conditions of the chosen contract.

Combination of Contract and Government Regulation

Under this approach, the deposit insurer will first find the most suitable contract, i.e. the contract whose conditions match some or most of the deposit insurance operations. Any aspect of operations that is not in line with the conditions will be addressed by government regulation.

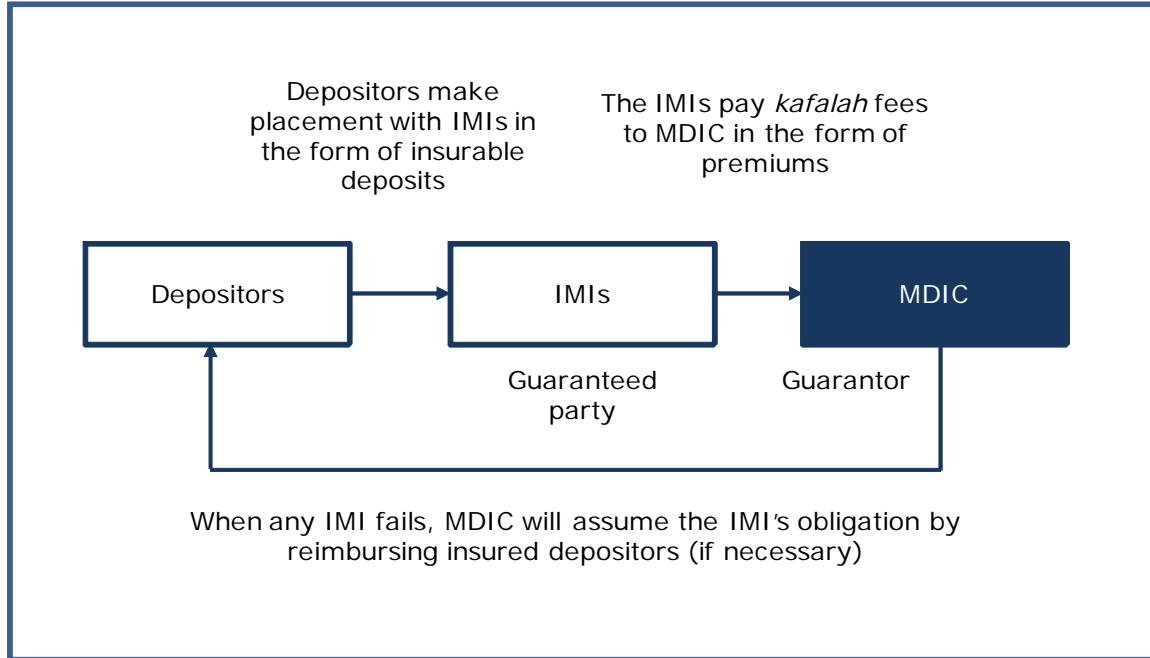
For instance, the government has assessed and decided to adopt a *takaful* contract for its IDIS. As a *takaful* contract involves voluntary contributions or premium payments from the IBIs, the government could issue a regulation making premium payments mandatory.

IX. Case Study 1: Malaysia's Approach in Implementing IDIS

As mentioned earlier, Malaysia implemented a dual deposit insurance system following implementation of a dual banking system. Separate deposit insurance systems for Islamic and conventional deposits were introduced in September 2005 following the enactment of the Malaysia Deposit Insurance Corporation Act 2005 (MDIC Act). The IDIS operates separately, but in parallel with the conventional system, and both systems are administered by Malaysia Deposit Insurance Corporation (MDIC).

To ensure a Shariah-compliant system, MDIC adopted a contract-based approach, where operations are based on a contract of guarantee with fee (*kafalah bil ujr*). The contract has been endorsed by the Shariah Advisory Council of Bank Negara Malaysia (BNM). The following chart shows the mechanism of the guarantee with fee contract for Malaysia's deposit insurance system.

Chart 1: Malaysia's IDIS mechanism



Under the contract, the salient features of the IDIS in Malaysia are as follows:

Funding and Premium Assessment

The operations of the Islamic deposit insurance are funded by premiums received from the IBIs, comprising Islamic banks and Islamic banking windows of commercial banks. Annual premiums are assessed based on the amount of insured Islamic deposits held as at 31 December of the preceding year. From 2005 to 2007, the IBIs' premiums were assessed on a flat rate basis. In 2008, MDIC introduced a differential premium system, whereby the IBIs are required to pay annual premiums based on their respective risk profiles. IBIs with higher risk profiles pay higher annual premium rates than those with lower risk profiles.

Coverage

MDIC provides equitable insurance protection for Islamic and conventional deposits. As such, Islamic deposits enjoy distinct and separate protection from conventional deposits. Islamic deposits that are eligible to be insured include savings, demand and investment deposits accepted under *mudharabah* (profit-sharing) and non-*mudharabah* contracts (e.g. *wadiah*, *qard*, and *murabahah*). Following the implementation of the Government Deposit Guarantee in October 2008, deposits held by IBIs enjoy coverage

over and above that provided by the explicit deposit insurance system, and deposits held by guaranteed institutions are also protected until the end of 2010.

Management of Islamic Deposit Insurance Fund

Premiums less permissible expenditures are maintained and administered separately in the Islamic Deposit Insurance Fund (IDIF). MDIC keeps separate accounting records and prepares separate financial statements for the Islamic and for the conventional deposit insurance systems. MDIC is required to invest in Shariah-compliant instruments. Currently, its investments are restricted to those issued or guaranteed by the government or BNM. Permissible expenditures are those incurred in Shariah-compliant activities only. In the event that MDIC intervenes in the affairs of a troubled IBI, MDIC is required by its statutory mandate to resolve the failure in such manner as to minimize costs to the financial system.

There is no commingling of funds or cross-subsidization between the Islamic and conventional deposit insurance funds. In the event that available funds are insufficient to carry out its mandate, MDIC would have access to government and market funding, which would be structured according to Shariah requirements.

Payment and Priority of Payments

To maintain confidence in the financial system, MDIC is required to reimburse insured depositors of a failed IBI quickly, and by law no longer than three months from the date of a winding-up order. All losses incurred by MDIC in meeting its obligations to insured depositors are to be charged to the IDIF.

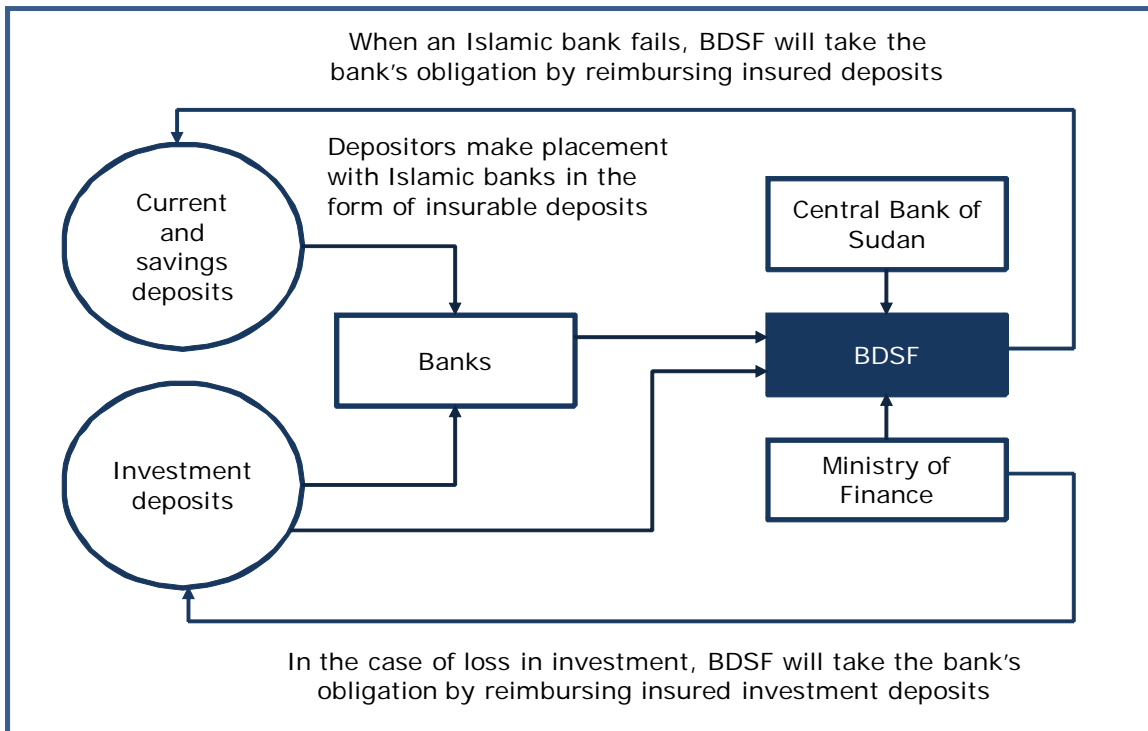
The priority of claims accorded to depositors affects the level of resolution costs incurred by MDIC. Under the provisions of the MDIC Act, depositors automatically subrogate their rights and interests, but only to the extent of any deposit insurance payment made. In respect of Islamic deposits, the priority of payments is based on the underlying contracts of the deposits, whereby non-*mudharabah* deposits are given priority over *mudharabah* deposits.

X. Case Study 2: Sudan's Approach in Implementing IDIS

In Sudan, the deposit insurance system for Islamic deposits was introduced in 1996, following the enactment of the Sudan Bank Deposit Security Fund Act 1996. The system is administered by the Bank Deposit Security Fund (BDSF).

To ensure a Shariah-compliant system, BDSF adopted the *takaful* contract for its deposit insurance. The contract operates based on cooperation between the Ministry of Finance, the central bank, the Islamic banks and the depositors themselves. The adoption of the *takaful* contract for Sudan's deposit insurance system was endorsed by the Shariah High Advisory Board of the Central Bank of Sudan. The following chart shows the mechanism of *takaful* for Sudan's system.

Chart 2: Sudan's IDIS mechanism



Funding and Premium Assessment

The operations of the IDIS are funded by the premiums received from the IBIs. Annual premiums are assessed based on the average total insured Islamic deposits held as at 31 December of the preceding year on a flat rate basis. The Ministry of Finance and the Central Bank of Sudan each pay 10% of the total amount of the annual banks' assessment.

BDSF manages the following *takaful* funds:

- (a) *Takaful* fund for the guarantee of current and savings deposits – assessable amounts shall only be paid by the Islamic banks, the Ministry of Finance and the Central Bank of Sudan;
- (b) *Takaful* fund for the guarantee of investment deposits accepted under *mudharabah* (profit-sharing) – assessable amounts shall only be paid by the owners of investment deposits themselves; and
- (c) *Takaful* fund for resolving cases of financial insolvency – assessable amounts shall only be paid by the Islamic banks, the Ministry of Finance and the Central Bank of Sudan.

Capital and Membership

BDSF's funding capital was provided through an initial contribution from the Central Bank, Ministry of Finance and the IBIs (membership fees). Membership is compulsory for all Islamic banks, which also includes foreign banks' branches.

Coverage

The maximum coverage limit with respect to current and savings deposits is SDG 3,000 (USD 1,500) per depositor per IBI, and the maximum coverage limit with respect to investment deposits is SDG 4,000 (USD 2,000) per depositor per IBI. These limits can be revised by the Board of Directors.

Payment and Priority of Payments

To maintain confidence in the financial system, BDSF is required to reimburse insured depositors of a failed IBI quickly, and by law no longer than three months from the date of a winding-up order. All losses incurred by BDSF in meeting its obligations to insured depositors are to be charged to the respective *takaful* fund, as appropriate. The priority of payments set out in the Banking Business (Organization) Act 1991 provides a basis for the reimbursement of depositors.

XI. Issues and Challenges

There are several issues and challenges in implementing an IDIS. First, given that Islamic deposit insurance is relatively new, there are no guiding principles available to aid in the development and establishment of an IDIS. Currently, only Malaysia and Sudan have set up an IDIS, while some other

countries provide protection for Islamic deposits under their conventional systems.

Second, the Islamic financial community is still debating whether PSIA's should be treated as deposits or investments, and whether they should be protected under the deposit insurance system.

Third, deposit insurers face the challenge of determining the insurability of deposit products and the priority of payment for each product. This issue is pertinent to Islamic banking given that some deposits are not accepted based on debtor-creditor relationship. Product innovation further escalates this challenge.

Fourth, deposit insurers face difficulties in investing surplus deposit insurance funds, as there are limited Islamic instruments.

Other issues include cross-border liquidation, liquidation of assets funded by restricted PSIA's and public awareness of the IDIS.

XII. Conclusion

The development of the IDIS marked another milestone in the evolution of the Islamic financial system. An IDIS protects Islamic deposits when an IBI fails, instills confidence among the general public as regards the safety of their deposits, promotes the stability of the financial system, and preserves the competitiveness of Islamic deposits. It also aims to meet the deposit insurance needs of the Muslim community.

An IDIS differs from a conventional system in that it is subject to Shariah requirements. To ensure a Shariah-compliant deposit insurance system, the government needs to adopt an appropriate approach, which could be different across jurisdictions, in light of differing Shariah interpretations or views from one jurisdiction to another.

The concept of Islamic deposit insurance is relatively new, and continuous research and development will be necessary, in order to address current issues and challenges as well as future needs.

Different countries may face different issues and challenges in implementing an IDIS. The best way forward is to bring IDIS practitioners together to share their respective issues and challenges and discuss ways to address them. This will provide input for the IDIG to recommend guidance on Islamic deposit insurance, for the benefit of all practitioners.

Appendix

IDIS in Sudan, Turkey, Malaysia and Indonesia

No.	Information	Sudan	Turkey	Malaysia	Indonesia
1	Name of deposit insurer	Bank Deposit Security Fund, Sudan (BDSF)	Savings Deposit Insurance Fund (SDIF)	Malaysia Deposit Insurance Corporation (MDIC)	Indonesia Deposit Insurance Corporation (IDIC)
2	Year of establishment of deposit insurer	1996	2001	2005	2005
3	Governance structure	The IDIS is established under specific legislation and administered by a government-owned deposit insurer	The IDIS is not established under specific legislation, and is administered by a government-owned entity	The IDIS is established under specific legislation and administered by a government-owned deposit insurer	The IDIS is not established under specific legislation, and is administered by a government-owned entity
4	Legal basis	Sudan Bank Deposit Security Fund Act 1996	Banking Act for deposit insurance	Malaysia Deposit Insurance Corporation Act 2005	Indonesia Deposit Insurance Law of 2004. The IDIS is governed by the same legislation as the conventional system, and is administered by an independent

No.	Information	Sudan	Turkey	Malaysia	Indonesia
					institution established by the government
5	Adoption of any Shariah-based contract for the IDIS (Y/N)	Yes	No	Yes	No
6	Availability of mandates to protect Islamic deposits (Y/N)	Yes	Yes	Yes	Yes
7	Specific mandates	BDSF Act 1996	Banking Act Article 63: savings deposits and participation funds belonging to real persons in credit institutions shall be insured by the Savings Deposit Insurance Fund.	Section 49 of the MDIC Act 2005 provides that MDIC shall separately insure Islamic and conventional deposits placed with a member institution.	The Deposit Insurance Law stated that insurance coverage also includes Shariah products/deposits
8	Number of Islamic banking units in country	More than 10	Less than 5	More than 10	More than 10
9	Percentage of share of Islamic banking assets	More than 10% (fully Islamic)	Less than 5%	More than 10%	Less than 5%

No.	Information	Sudan	Turkey	Malaysia	Indonesia
10	Membership (mandatory or not)	Mandatory	Mandatory	Mandatory	Mandatory
11	Types of institution covered	All banks	Participation banks	Islamic banks and Islamic banking windows. (Following the implementation of the Government Deposit Guarantee (GDG) in October 2008, the types of institution covered were extended to: - International Islamic banks - Development financial institutions offering Islamic deposits)	Islamic commercial banks and Islamic windows of conventional commercial banks, Islamic rural banks
12	Types of deposits covered	The total of all deposits in local currency, with the exception of: - Any amounts due to a foreign	Participation and special current accounts	- All deposit products including current, savings and investment deposits	Checking accounts with <i>mudharabah</i> and <i>wadiah</i> contracts, savings accounts with <i>mudharabah</i> and <i>wadiah</i> contracts,

No.	Information	Sudan	Turkey	Malaysia	Indonesia
		<p>state, a public institution or corporation, any of the federal or states' ministries, local government bodies or any other bank</p> <ul style="list-style-type: none"> - Any amounts due on a deposit delivered outside Sudan - Any amounts due to a banking institution which does not operate in Sudan 		<ul style="list-style-type: none"> - Certified cheques, bank drafts and other similar payment instructions - Any other financial instruments as may be specified by MDIC from time to time <p>(With the implementation of the GDG, all Islamic deposits/ instruments, including structured deposits, foreign currency deposits and negotiable instruments of deposit held by non-banks, are guaranteed)</p>	<p>time deposit with <i>mudharabah</i> contracts.</p> <p>[Note: In Indonesia, <i>mudharabah</i> contracts are based on revenue-sharing, not profit- and loss-sharing. The bank pays the overheads out of its proportion/ratio]</p>
13	Types of deposits not covered	<ul style="list-style-type: none"> - All deposits in foreign currency - Deposits attached as a 	Participations and special current accounts that do not belong to real	<ul style="list-style-type: none"> - Deposits not payable in Malaysia - Foreign currency 	Accounts with <i>mudharabah muqayyadah</i> contract, where risks are borne

No.	Information	Sudan	Turkey	Malaysia	Indonesia
		<p>guarantee or security against banking operations</p> <ul style="list-style-type: none"> - The deposits of the chairman and members of the board of directors, and the general manager of any guaranteed bank, and the deposits of their spouses and minor children - The deposits of shareholders who bear any responsibility with respect to the non-soundness of the bank concerned, and the deposits of their spouses and minor children - The deposits of the chartered 	<p>persons</p>	<p>deposits</p> <ul style="list-style-type: none"> - Money market deposits - NIDs and other bearer deposits - Any other financial instruments as may be specified by MDIC from time to time <p>(Since implementation of the GDG, the following deposits/ instruments are not guaranteed:</p> <ul style="list-style-type: none"> - Deposits payable outside Malaysia - Interbank money market placements - Negotiable instruments of deposit held by banks) 	<p>solely by depositors</p>

No.	Information	Sudan	Turkey	Malaysia	Indonesia
		accountants appointed to audit the accounts of the bank concerned - Any such deposits as the Board may deem to have been obtained by illegal means - Any company in which the bank is the majority shareholder - Any other deposits whose exclusion the Board may deem appropriate			
14	Coverage limit (per depositor per member institution): (a) Islamic	- SDG 4,000 (USD 2,000) for investment deposits - SDG 3,000	TRY 50,000 (USD 30,000)	MYR 60,000 (USD 17,150)	One limit for conventional and Islamic deposits in one bank/institution. If a conventional bank

No.	Information	Sudan	Turkey	Malaysia	Indonesia
	(b) Conventional	(USD 1,500) for current deposits Not applicable (fully Islamic system)	TRY 50,000 (USD 30,000)	MYR 60,000 (USD 17,150) (Following the implementation of the GDG, guaranteed deposits are covered in full)	has an Islamic window, customer deposits in both products will be aggregated up to the IDR 2 billion coverage limit
15	Type of funding (ex ante or ex post)	Ex ante	Ex ante	Ex ante	Ex ante
16	Separate assessment of premiums (Y/N)	Not applicable	No	Yes	No
17	Similar premium rates (Y/N)	Not applicable (fully Islamic system)	Yes	Yes	Yes
18	Separate maintenance of Islamic fund	Not applicable	No	Yes	No

No.	Information	Sudan	Turkey	Malaysia	Indonesia
	(Y/N)				
19	Separate management of Islamic fund (Y/N)	Not applicable	No	Yes	No
20	Management of Islamic fund in accordance with Shariah (Y/N)	Yes	No	Yes	No
21	Priority of payments for Islamic deposits regulated by contract	All deposits are Islamic deposits	No	Yes	No
22	Borrowing from the government or market in the event of inadequate funds	Yes	Yes	Yes	Yes
23	Type of borrowing (conventional or Shariah-based contract)	Shariah-based contract	Conventional contract	Shariah-based contract	Yet to be decided

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Glossary

***Ijarah* (leasing)**

A form of leasing in which there is a transfer of ownership of a service for a specified period for an agreed lawful consideration. Instead of lending money and earning interest, Ijarah allows the financial institution to earn profits by charging rental on the asset leased to the customer.

***Mudharabah* (profit-sharing)**

A form of partnership where one party provides funds (investor) while the other provides expertise and management (entrepreneur). Profit is shared between the two parties according to an agreed profit-sharing ratio, while any loss is borne by the provider(s) of the capital. In the event of negligence, the loss will be borne by the fund manager.

***Murabahah* (cost-plus)**

A sale on mutually agreed profit where the seller charges the buyer the cost plus a profit.

***Musyarakah* (profit- and loss-sharing)**

A partnership in which profits are shared according to an agreed ratio, while losses are shared in proportion to the capital/investment of each partner. In a *Musyarakah*, all partners to a business undertaking contribute funds and have the right, but not the obligation, to exercise executive powers in that project, which is similar to a conventional partnership structure and the holding of voting stock in a limited company.

***Qard* (loan)**

A loan contract in which the borrower is only obligated to repay the principal amount of the loan.

***Takaful* (joint guarantee)**

A scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need, whereby the participants mutually agree to contribute for the purpose.

***Wadiyah* (safe custody)**

A safe custody contract which is based on trust; only the principal amount must be repaid to the customer.

***Wakalah* (agency)**

Contract of agency in which a person delegates his business to another and substitutes the other in his own place. The latter is the agent and the former the principal.