Towards a universal Islamic deposit insurance system

In the first of a two-part series, Mohammed Khnifer shares his research which highlights how the concept of Islamic Deposit Insurance (IDI) developed in the Muslim world.

IDI is a Shari’ah-compliant system that provides protection to depositors against the potential loss of an Islamic bank’s failure. The concept of deposit insurance in the Islamic finance industry is still relatively new as practitioners are struggling to comprehend whether it conforms to Shari’ah. Very few countries with Islamic economies have an IDI system in place as it is a complicated balance between maintaining profit-loss sharing Shari’ah principles and protecting bank customers.

The concept of insuring Islamic deposits started in GCC countries 10 years ago, however the concept did not reach maturity until it was institutionalised and adopted in Malaysia.

Due to the absence of guidelines and papers on this topic, it is imperative to point out the controversial areas in designing IDI systems and how they were resolved. The Malaysian model is being heavily reviewed and the researchers at the International Association of Deposit Insurers (IADI) are trying to understand whether such a system can enhance the stability of the Islamic financial system. Therefore, it makes sense for this research to examine the Malaysian IDI system and to look into the possibility of its adoption in the GCC.

SEGREGATION OF FUNDS
Between 2000 and 2004 researchers started to debate whether there is a need to insure some types of Islamic banking accounts. Banks with Islamic windows used to commingle the Shari’ah deposits with conventional funds (and used for conventional purposes) or provided Islamic returns that may have been derived from such commingled sources. Some Shari’ah scholars observed this and asked commercial banks to establish appropriate controls to avoid the commingling of Islamic and conventional funds.

In operational terms, this required banks to establish different capital funds and separate accounts, books and reporting systems evidencing the complete segregation of funds. Indeed, before designing any IDI scheme, it is a requirement to separate streams.
of cash flows and block any leakages. This separation of funds caused the first thoughts about deposit insurance for Shari’ah-compliant accounts.

Sources of funds in Islamic banks can be grouped into four general categories: Islamic banking funds; customers’ deposits; corporate banking activities; and treasury activities or placements. It is estimated that the financial institutions offering Islamic products now collectively hold $750 billion of assets. Of this, $350 billion is held by fully Islamic financial institutions and the remaining $400 billion by conventional banks that offer Islamic banking services.

In early 2000, there were lively debates over which of the customers’ deposits should be guaranteed. Before we examine these deposits, we need to point out that Islamic banks do have demand deposits, savings deposits, and general and special investment deposits. Savings and demand accounts are normally based on Wadiah (safe custody or safe keeping with guarantee) or Qardul Hassan (benevolent loan) contracts, while general and specific investment accounts are based on Mudarabah.

Under Wadiah Yad Dhamanah, where the nominal value is guaranteed, Islamic banks act as custodian or guarantor of the funds deposited by customers, e.g., demand deposits. Customers may withdraw their balances at any time. By using this product, depositors no longer supply funds to earn a fixed income. Instead, they place deposits for protection. Banks are not supposed to use these funds as a source of investment and financing or risk-bearing projects. However, in reality they do.

It is hard to quantify those banks that use Wadiah accounts, but we do know that some banks provide a token of appreciation known as hibah to depositors for banking with them. It should be noted that since the custodian service is given without a price, the Islamic bank holds no legal obligation to pay depositors a fixed return and may do so only on voluntary basis. However, the banks are obliged to reimburse the funds at par value to their depositors in the event that a loss does occur.

The second type of widely used contract for Islamic deposits is Qardul Hassan. Under the Islamic Fiqh Academy ruling, shareholders are obliged to guarantee those deposits because they received returns from utilising the deposits in investment projects.

**PLS DEPOSITS**

The profit and loss sharing (PLS) or Mudarabah forms the bulk of Islamic deposits. PLS was and still is a centre of debate on multiple levels. To begin with, The prohibition of interest in Islamic banking is replaced by PLS arrangement whereby the rate of return on financial assets held with banks is not known and not fixed prior to the undertaking of each deposit transaction, also known as ex-post rate. In this partnership structure, no guarantee is given for capital protection or a fixed income. This product structure is run under the principle of sharing equity. Unfortunately this makes it a risky product for depositors as the underlying contract is based on profit-loss sharing system.

Under a Mudarabah contract, the depositors act as providers of funds who place a specified sum of money to the bank, while Islamic banks act as entrepreneur through investing the funds and sharing the investment profit according to the predetermined profit sharing ratio. Profits are acquired only when the investments are gaining ground, while capital may depreciate or even diminish if the investment does not turn a profit. Banks bear the entirety of the loss if there is negligence and mismanagement on the part of the bank.

While conventional banks guarantee the capital and rate of return, the Islamic banking system cannot provide such to PLS depositors. Some practitioners in the industry would argue that insuring a deposit goes against the PLS principle. Hence, depositors will not incur any risk, which contradicts the basic concept of Mudarabah. Other researchers are beginning to debate if protecting Muslim depositors’ funds, by providing guarantee, can erode Shari’ah principles.

Before Malaysia took the helm, the concept of designing a complete IDI system started in the GCC as a relatively innocuous idea that was based on understanding the economic and Shari’ah justification of the necessity of protecting depositors by guaranteeing PLS. For example, depositors are the...
ones who provide funds for specific investment activities by the bank. Thus, shareholders should consider sharing their distributed profits fairly to the small depositors who are bearing the risk.

The second justification on why Islamic banking scholars favoured a guarantee of investment deposits (PLS) was based on the fact that conditions of Mudarabah contracts were not applicable to investment deposits and therefore the bank should guarantee nominal value on the deposits. It is unclear as to how many GCC banks established, at that time, in-house IDI based on the concept of Tabarru. As far as how the concept works, we know that banks retain a fraction of the yearly shareholders’ income in a special account for shareholders which would be used to compensate the depositors for any loss of their principal amount that may occur when taking risks with their money. For instance, a Saudi bank sustained large losses around the same time and its Board of Directors decided to have the bank’s owners bear this loss on behalf of the owners of the investment accounts.

Maintaining such an account from contributions from shareholders’ income will be similar to paying an insurance premium to a third party to guarantee the depositors’ principal amount.

Prior to the Malaysia Deposit Insurance Corporation (MDIC)’s establishment in 2005, Malaysian banking officials were monitoring these non-institutionalised efforts in the GCC to design in-house deposit insurance schemes. Indeed, it was reported that the MDIC studied several other frameworks including donation (Tabarru’), agency (Wakalah), and an approach based on government regulations (Siasah Syar’iyyah). The Shariah Advisory Council (SAC) of Bank Negara Malaysia decided to adopt the Kafalah bil Ujr structure as the most viable option. Keep in mind that the ‘Tabarru’ concept was internally implemented by some GCC banks even though there were no third-party guarantees in place.

For a country striving to lead the way in developing standard international best practices relating to IDI, the concept of Tabarru’ was not the answer. In its argument, the MDIC stressed that Tabarru’ might not be sufficient to convince central banks that Islamic institutions could provide a guarantee as a voluntary rather than an obligatory act. It added that if Islamic banks were allowed to provide a guarantee as a Tabarru’ act, they might abuse it and provide a guarantee for Mudarabah investment deposits, and then allege that it was not an explicit guarantee, but only Tabarru’.

LAYERING THE FOUNDATIONS

There are many hurdles that may stand in the way of developing a sound IDI system. In order to understand how to overcome such obstacles, the MDIC will be at the centre of this case study.

The vast majority of Islamic and Western countries have a dual banking system, which makes it difficult to design a deposit insurance model that is compatible with the principles of Islamic finance. The Malaysian deposit insurance system was introduced in September 2005 and was the first deposit insurance system to provide separate protection for conventional and Islamic deposits under one organisation. Without such an entity, there would be a complete lack of consumer protection in the Islamic banking system. This would undoubtedly create an unfair disadvantage in the evolution and stability of the Islamic banking system.

The Shariah Advisory Council of Bank Negara Malaysia, which has one of the most respected groups of scholars in the Islamic banking industry, issued a Fatwa prior to the establishment of the IDI system that emphasised the need...
to separate funds in the operation of deposit insurance schemes for Islamic banking to ensure that the funds of such a scheme are invested in Shari’ah-compliant instruments. For Malaysia, it was already in compliance with that, but for the other few countries that have an incomplete IDI system, they were not.

While other regulators lacked the willingness to make an effort to eliminate the commingling of Shari’ah and conventional deposits, others failed to separate Islamic deposit insurance funds from conventional funds after receiving the scheme’s insurance premiums.

According to Moha-Pisal Zainal, INCEIF Joint Director of Research, Indonesia has one pool where all the premiums and returns out of purchasing securities are mixed. Hence, the paid capital of the IDI fund has been contaminated with conventional funds.

As in the GCC, the PLS or Mudarabah investment accounts were the centre of debate in Malaysia as observers argued as to whether PLS depositors should be protected. The MDIC laid down two reasons why these accounts should be protected.

First, deposit insurance is a prudential measure to promote the stability of the financial system due to a significant proportion of PLS vis-à-vis other types of deposit products in the Islamic banking industry. The public’s interest should be taken into consideration as PLS accounts for more than 45 per cent of total Islamic deposits and therefore accounts for the bulk of deposits mobilised in the Islamic banking.

Second, the protection will only take effect in the event of a bank’s failure. In the normal course of banking operations the loss arising from investing PLS accounts will continue to be borne by the PLS holders. As such, the nature of the Mudarabah contract remains enforceable and the conditions are not voidable.

Under the Mudarabah contract, the entrepreneur is not allowed to guarantee the principal amount of PLS accounts. However, in 2003, Elgari issued a fatwa for the permissibility of such guarantees as long as it came from an unrelated third party. After that, the Shari’ah Advisory Council resolved that a third party guarantee is allowed to protect Mudarabah investment accounts. If an Islamic bank fails, MDIC would reimburse the PLS account holder up to the limit of deposit insurance coverage based on the value of their deposit at the date of payment and subject to priority of claims.

PUBLIC INTEREST

One of the justifications for setting up an IDI is for the public’s interest (Maslahah) and the banking industry as a whole. According to MDIC, their Islamic deposit insurance system contains the element of Maslahah in the several areas.

First, the main objective of establishing a deposit insurance system is to protect the public’s money and prevent the public from facing financial difficulty in the event of a bank failure. Such hardship would affect people’s lives and cause even greater hardship to those who have limited financial resources.

Second, IDI instills public confidence in the safety of depositors’ funds in banks. The act of instilling confidence amongst members of the public in the safety of their deposits contributes and promotes to financial stability.

It also promotes the competitiveness of the Islamic deposits and the banking system. Without the protection, Islamic deposits may lose their competitiveness against the conventional deposits which enjoy such protection. As a result, there is a possibility depositors would withdraw their funds in Islamic banks and place them in conventional banks. This would create liquidity issues to Islamic banks and dampen the development of the Islamic banking industry.

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Continued next month...