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Update On Islamic Deposit Insurance Issues

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What is the Nature of Islamic Banking?

The emergence of interest-free financial institutions, which operate in accordance with Islamic law (Shariah), has created a new dimension widely known as Islamic banking.

One of Islamic banking's most notable characteristics is that it is interest-free. Islamic law (Shariah) prohibits charging or paying interest (riba) regardless of the purpose for which loans are made and regardless of rates. Nevertheless, like any other business entity, Islamic banks are expected to generate profits from their operations and provide sufficient returns to the depositors who entrusted their money to Islamic banks. Thus, Islamic banks have to incorporate both profit and morality into their objectives.1

Basically, sources of funds in Islamic banks can be grouped by four categories i.e. Islamic banking funds, customers' deposits, corporate banking activities, and treasury activities or placements. However, this Research Letter will mainly focus on customer's deposits such as 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 Qard (loan) contracts, while general and specific investment accounts are based on Mudarabah.

Under Wadiah Yad Dhamanah (safekeeping with guarantee), Islamic banks act as custodian or guarantor of the funds deposited by customers i.e. demand deposits. Customers may withdraw their balances at any time. In this scheme, banks can use funds as a source of investment and financing for risk-bearing projects.

As well, profits generated from the investment belong to Islamic banks. The banks, however, are obliged to reimburse the funds at par value to their depositors when funds under custody suffer a loss.

The prohibition of interest in Islamic banking is replaced by profit-and-loss sharing (PLS) arrangements such as Mudarabah 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 (Sun and Philips 2002).2 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. If the investment resulted in a loss, the loss must be borne by the owner of the capital i.e. depositors under Mudarabah. What makes profit-sharing permissible in Islam, while interest is not, is that in the case of the former it is only the profit-sharing ratio, not the rate of return itself that is predetermined (Ariff 1988).

Characteristics Islamic Banking Conventional Banking:

Why is there an interest in Islamic Deposit Insurance?

Islamic banking has emerged on the world scene as a new financial market since last four decades. The successful setting-up of the first Islamic bank, MitGhamr Local Saving Bank in 1963 and the Islamic Development Bank in Dubai back in 1975 paved the way for the establishment of Islamic financial institutions throughout the world. Today, Islamic banks are expanding the traditional borders of Muslim economies into Europe, U.S.A. and the Far East. As a result of the profound global growth in Islamic banking & finance, the International Monetary Fund estimates that there are currently more than 300 Islamic financial institutions in over 75 countries around the world. The Financial Times also reports that Moody's estimated recently using data from across the Muslim world, that there are 250 Islamic mutual funds in the world, with over USD300bn of assets, while another 300 Islamic financial institutions hold USD250bn of assets and special Islamic windows

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or branches of non-Muslim conventional banks hold some USD200bn of assets.

In the context of Islamic banking principles, although an Islamic bank may fail to meet its depositors demand at par value, it cannot be automatically considered as financially insolvent because of the distinct characteristics of Islamic banking. If not corrected in due course, however, this would progressively reduce the banks' intermediation role and hamper the mobilization of private savings towards investment, since no depositors would keep their money within the financially troubled bank.

Therefore, even in the traditional version of Islamic banking, insolvency risks cannot be ruled out, notably in cases where banking operations are carried out according to a two-tiered Mudarabah arrangement (Errico and Farabaksh 1998). Under certain circumstances, even demand deposit may not be guaranteed as to their par value when bank soundness is deteriorated by poor investment decisions.

Hence, Islamic banks are also exposed to bank-run risks when the financial system loses public confidence. Deposit insurance systems - whether they are explicit or implicit - can play an important role in mitigating bank-runs and thereby promote financial stability.

Among Muslim scholars and policymakers, there is an increasing interest on the need of adopting a deposit insurance scheme into the Islamic banking. In this regard, Zakariya Othman, the editor of the Islamic Finance News stated in its recent issue that:

"A fundamental distintion of an Islamic bank is the lack of the deposit insurance common in conventional banks:

Calls have been made for initiatives to help protect deposits against such risk, and several Muslim scholars think that deposit insurance scheme should be an integral part of the Islamic banking system. (• • •) Turkey has emerged ahead of other countries in pushing for protection of depositors in Islamic banks. (• • •) It has allowed Islamic banks to set up a parallel Islamic deposit insurance scheme, which is similar to its conventional counterpart in everything except that the Islamic scheme only invests the deposit insurance pool according to Islamic investment principles. (• • •) The scheme, introduced in July 2003, was the first Islamic deposit insurance scheme in the world, and was followed by Malaysia in September 2005. Surprisingly, these are the only two countries that provide such a financial net for depositors in Islamic banks, although countries like Bahrain, Lebanon and Jordan have already adopted the deposit insurance scheme for conventional banks. (• • •) According to the World Bank Policy Research Working Paper 3628, dated June 2005, countries like Iran, Kuwait, Qatar, Saudi Arabia and the UAE have basically adopted the deposit insurance scheme implicitly, and thus there is no formal regulation that explains the scheme."(several passages in-between omitted)3

What are the issues for deposit insurers and what makes them different from other deposit insurance issues?

In Islamic banking, structural and operational design features of Islamic deposit insurance systems should comply with Shariah principles.

Bank Negara Malaysia recently conceived the concept of a separate Islamic deposit insurance system in relation to eligible Islamic deposits. This operates separately but parallel with the conventional deposit insurance system. To ensure that the Islamic deposit insurance system complies with Shariah principles, deposit insurance (the insurance contract) is based on the concepts of Kafalah (guarantee) and Ta'barru (donation).

In line with these principles, the relevant member institutions make donations to the Malaysia Deposit Insurance Corporation (MDIC), which then provides depositors with coverage and ensures payouts in the event of failure.4

Bearing the basic understandings of Islamic banking, it is worthwhile to take a look at some key issues for deposit insurers under an Islamic banking system and the different features compared to those for conventional deposit insurers. For those who are considering the adoption of new Islamic deposit insurance system, or the reform of an existing deposit insurance system, it is worthwhile to pay special attention to the following issues:

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Constitution of the Islamic deposit insurance system in compliance with Shariah principles

Coverage:

Which deposits are covered under the deposit insurance system? Should investment deposits be covered?; What is the deposit insurance limit under an Islamic deposit insurance system and how is this limit applied?; If a country has already an established conventional deposit insurance system, is the insurance coverage limit per depositors under Islamic deposit insurance comparable or equal to the limit of the conventional deposit insurance system?

Funding:

What funding mechanisms are available to deposit insurers in compliance with Shariah principles?; How can deposit insurance be managed without contradicting Shariah principles?; Which assessment scheme is more appropriate to the Islamic deposit insurance system?

Bank closure and failure resolution:

Once an insolvent bank has been identified, does a process exist for handling that bank? What is a deposit insurer's role in the process?

In the Malaysian case, Islamic deposits eligible for coverage include demand and investment deposits, both Mudarabah and non-Mudarabah, but exclude deposits payable outside Malaysia, foreign currency deposits, negotiable instruments of deposit, other bearer deposits and repurchase agreements (as is the case for conventional deposits).

Since investment deposits with PLS arrangements form the bulk of Islamic deposits, the system might lose its effectiveness and have difficulty in maintaining the public confidence if such deposits are not covered under the system.While a deposit insurance system can contribute to stability and thereby promote economic growth, it perversely enables banks to pursue excessive risk-taking, i.e. a moral hazard problem is evident. Unlikely to the Malaysian case, deposits with PLS arrangement such as mutual funds or investment trust products are not generally covered under some conventional deposit insurance system.

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