



*Forum Theme: Strengthening Financial Safety Nets in the  
Islamic Financial Services Industry*

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## Implementation of an Islamic Deposit Insurance System for the Islamic Financial Services Industry

*Paper by:*

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The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes the issuance of exposure drafts and the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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# **Implementation of an Islamic Deposit Insurance System for the Islamic Financial Services Industry**

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## **1.0 Background of the Islamic deposit insurance system**

The Islamic deposit insurance system<sup>1</sup> is an arrangement to protect insured depositors against the loss of their insured Islamic deposits placed with Islamic banking institutions (IBIs) in the event of the failure of an IBI.

The concept of deposit insurance in the Islamic financial industry is relatively new. Few countries have implemented deposit insurance, and little has been written about its development and implementation.

Within the current landscape of the Islamic financial industry, only Sudan and Malaysia have implemented an ex-ante Islamic deposit insurance system, whereas conventional deposit insurance systems have been implemented in over 100 countries. In an ex-ante deposit insurance system, premiums are collected from member banks before a failure occurs. Sudan introduced its Islamic deposit insurance system in 1996, and Malaysia followed in 2005. Turkey's Islamic deposit insurance system (developed in 2001) was absorbed into its conventional system in 2005.

In countries such as Turkey, Indonesia and a few others, Islamic deposits in Islamic financial institutions are protected under the countries' respective conventional deposit insurance systems. Other countries around the globe that offer Islamic deposit products, on the other hand, do not offer any explicit protection for Islamic deposits. Nevertheless, several countries that protect Islamic deposits under the umbrella of the conventional deposit insurance system, or which do not offer explicit protection to Islamic deposits, have expressed their intention to establish an Islamic deposit insurance system.

The system has yet to be implemented in other countries due to, among other reasons, the small size of Islamic deposits compared to total deposits in the overall financial system. Lack of clarity on the insurability of profit-sharing investment accounts (or PSIA),

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<sup>1</sup> In this paper, "Islamic deposit insurance system" has a similar meaning to "Shari'ah-compliant deposit insurance system". These terms shall be used interchangeably.

which form the bulk of total Islamic funds, also impedes the development of the Islamic deposit insurance system.

## **2.0 The need for an Islamic deposit insurance system**

Despite the current low presence of a *Shari'ah*-compliant deposit insurance system globally, it has attracted considerable attention and growing interest in how to implement such a system so that it complements the existing financial safety nets within the Islamic financial industry.

This growing awareness is due to the growth of the Islamic financial industry, not only in countries with majority Muslim populations but also in the Western world. Today, the Islamic financial industry has emerged as a vibrant, dynamic and competitive global intermediation mechanism. With more than 300 Islamic financial institutions licensed in over 75 countries, its assets are projected to grow to USD1.6 trillion globally by 2012.

The Islamic financial industry is anticipated to expand further to cater to the needs of the growing Muslim population that has almost reached one-fourth of the world's population. Comprehensive demographic statistics taken from 232 countries indicate that 1.57 billion Muslims live in the world today, which translates into 23% of the 2009 world population projection of 6.8 billion.

The recent global financial crisis that affected conventional financial institutions resulted in many parties beginning to appreciate Islamic finance as a promising alternative. The Islamic financial system, which inculcates better discipline into the economy and links credit expansion to the growth of the real economy, may be capable of minimising the severity and frequency of financial crises.

A *Shari'ah*-compliant deposit insurance system may be needed for other justifications. First, Islamic deposit insurance could provide protection to profit sharing investment accounts (PSIA) where the conventional deposit insurance system may not be able to do so. Protecting PSIA will therefore create a level playing field between the Islamic and conventional banking products, and this can further propel the growth of the Islamic financial industry by reducing the potential outflow of Islamic deposits from IBIs to conventional banks.

Second, the Muslim community aspires to have a deposit insurance system that is in line with *Shari'ah* requirements and fits in with their way of life. In this regard, the system must not contain elements that are strictly prohibited, such as interest, uncertainty and gambling. This is more relevant in countries with majority Muslim populations who

demand a comprehensive Islamic financial system covering Islamic banking and Islamic deposit insurance.

Lastly, establishing an Islamic deposit insurance system could be beneficial to a country that practises Islamic finance. A comprehensive safety net within the Islamic financial industry would contribute to the strength of the system.

### **3.0 Developing an Islamic deposit insurance system**

The role of Islamic and conventional deposit insurance systems is generally similar, whereby the deposit insurer collects premiums from banks and protects the insured depositors of a failed bank.

In developing *Sharī'ah*-compliant deposit insurance, the adoption of some general features of conventional deposit insurance, such as operating the system under an ex-ante or ex-post model, as a paybox or risk minimiser model, and so on, shall be considered first. Any features that do not comply with the *Sharī'ah* precepts shall then be removed.

Under the Islamic deposit insurance system, expenses incurred and any investments of the Islamic deposit insurance fund must comply with *Sharī'ah* principles, whereby only permissible expenses are paid by the Islamic fund and the fund is invested in Islamic instruments.

Other differences between Islamic and conventional deposit insurance are as follows:

- i. The products covered under Islamic deposit insurance are Islamic deposits and may be extended to PSIA. Under conventional deposit insurance, the protected deposits are conventional deposits.
- ii. Members of Islamic deposit insurance are IBIs, while under the conventional system the members consist of conventional banking institutions.<sup>2</sup>
- iii. Under Islamic deposit insurance, premiums are paid from the IBI's own fund. In the case of PSIA, premiums may be paid from the PSIA holders' fund. Under the conventional system, premiums for conventional deposits are paid from the conventional banking institution's fund.

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<sup>2</sup> In the absence of an Islamic deposit insurance system in some jurisdictions, IBIs are members of the conventional deposit insurance system.

- iv. In terms of reimbursement to depositors, the Islamic deposit insurance fund is utilised for the purpose of reimbursing depositors of Islamic deposits. Reimbursement for conventional deposits is made from the conventional deposit insurance fund.
- v. Under the Islamic deposit insurance system, reimbursements of Islamic deposits and unrestricted PSIA are prioritised based on their respective *Sharī'ah* contract. Under the conventional system, all deposits are ranked *pari passu*, which means all deposits rank equally and reimbursement of these deposits shall be given similar priority.
- vi. In the case of liquidation of a failed member bank under the Islamic deposit insurance system, the assets of restricted PSIA shall be liquidated separately; this is not the case for the conventional counterpart that does not offer PSIA products.
- vii. Under Islamic deposit insurance, countries that choose to practise the differential premium system may use key financial indicators that are tailored to assess the risk profiles of IBIs (especially unique risks); these may differ slightly from the indicators used to assess conventional banks' risk under the conventional deposit insurance system.

The implementation of an Islamic deposit insurance system will depend on how the government in the respective country views the permissibility of the system from the *Sharī'ah* perspective.

There are generally several approaches that a government could take in implementing a *Sharī'ah*-compliant deposit insurance system – namely, government regulation, *Sharī'ah* contract, or a combination of both. However, the permissibility of these methods is subject to the endorsement of *Sharī'ah* authorities in the respective jurisdictions.

Under government regulation, the government effort to set up an Islamic deposit insurance system is regarded as being in line with the Islamic concept of *Siyāsah Shar'īyyah*. *Siyāsah Shar'īyyah* refers to any action taken by the government in the interest of the public, or *Maslahah*. The government, in the absence of a *Sharī'ah*-compliant approach, implements the 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 are few alternatives to Islamic 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. As long as the deposit insurance system does not contradict any substantive principle of *Sharī'ah*, there is no harm in introducing, implementing, executing or enforcing it.

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 *Sharī'ah* scholars, believes that the public interest argument alone is insufficient to justify a *Sharī'ah*-compliant deposit insurance system.

Adoption of a *Sharī'ah* contract is the best available means to reflect the intention and consent of contracting parties. In the *Qur'ān*, there are several verses on several types of commercial contracts. There are some contracts available which could be examined and assessed on their applicability to an Islamic deposit insurance system, such as *Kafālah bil 'Ujr* (guarantee with fee) and *Takāful* (mutual guarantee) contracts.

It is important to note that different contracts come with different conditions or requirements, and thus it is possible to create deposit insurance systems 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 deposit insurance public policy objectives and salient features with the conditions of the chosen contract. The various available contracts that may be used include *Hiwalah* (transfer of obligation), *Wakālah* (agency) and *Ijārah* (hiring/employment). Adoption of these *Sharī'ah* principles is subject, however, to interpretation by *Sharī'ah* authorities in the respective jurisdictions.

It is anticipated that challenges may arise when adopting the *Sharī'ah* contract approach alone. Therefore, the best solution for tackling the challenges is to combine the *Sharī'ah* contract and government regulation approaches. Under this method, the deposit insurer will first find the most suitable contract – that is, the contract with conditions that match most or some of the deposit insurance operations. Any aspect of operations that is not in line with the conditions will be addressed by government regulation, which is made permissible by *Siyāsah Shar'iyyah*. For instance, the government has assessed and decided to adopt a *Takāful* contract for its Islamic deposit insurance system. As a *Takāful* contract involves voluntary contributions or premium payments from the IBIs, the government could issue a regulation making premium payments mandatory.

#### **4.0 Malaysia's Islamic deposit insurance system**

Malaysia has implemented a dual deposit insurance system following the implementation of a dual banking system. The system was introduced in September 2005 pursuant to the enactment of the Malaysia Deposit Insurance Corporation Act (MDIC Act). Malaysia's Islamic deposit insurance system operates separately from the conventional system, but both systems are administered solely by the Malaysia Deposit Insurance Corporation (MDIC).

MDIC adopts a contract-based approach – *Kafālah bil `Ujr* – in the implementation of an Islamic deposit insurance system. The contract has been endorsed by the Shariah Advisory Council (SAC) of the Central Bank of Malaysia, the highest authority for resolving *Sharī`ah*-related matters in the Malaysian Islamic finance industry.

The contract of *Kafālah bil `Ujr* is an arrangement whereby a guarantor assumes the responsibilities and obligations of the party being guaranteed should claims arise. In this contract, MDIC acts as the guarantor and the IBIs as the guaranteed party. As consideration for the guarantee, the IBI pays a fee to MDIC in the form of annual premiums; in the event that the IBI fails, MDIC will assume the obligation of reimbursing insured depositors.

There has been ongoing debate about the adoption of the *Kafālah bil `Ujr* contract in any financial transaction, owing to the existence of the fee element in the contract. On the one hand, the majority of classical *Sharī`ah* jurists are of the view that charging a fee for giving a guarantee is not allowed, because a guarantee is a good deed that is voluntary in nature. On the other hand, several contemporary *Sharī`ah* scholars recognise the need to be allowed to charge a fee based on the current needs of the community.

For instance, SAC's justification for endorsing the *Kafālah bil `Ujr* contract is based on *Maslahah*, or public interest, whereby MDIC's role of guaranteeing Islamic deposits is in the interest of the public so that further detrimental effects on society in the event of a bank failure can be avoided.

In the current setting, to provide a guarantee without any consideration in return is rare. One contemporary *Sharī`ah* expert opined that a fee is necessary when providing a guarantee. In the context of MDIC, the fee paid is indeed necessary as it is used to fund the operations of MDIC and future losses arising from providing deposit insurance. In addition, it is allowable to charge a fee on the premise that it is not feasible to develop an Islamic deposit insurance system that is financed solely by the government or private funds. Deposit protection through a blanket guarantee could be costly to the government, which in turn would place a direct or indirect financial burden on the public.

The salient features of the Islamic deposit insurance system in Malaysia are as follows:

- i. The operation of the system is 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 premiums were assessed on a flat rate basis. Starting 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.

- ii. Eligible products to be insured include savings, demand and investment deposits accepted under *Muḍārabah* (profit-sharing) and non-*Muḍārabah* contracts (e.g. *Wadī'ah*, *Qarḍ* and *Murābahah*).
- iii. An Islamic deposit insurance fund is established and managed separately from a conventional deposit insurance fund and is invested in *Sharī'ah*-compliant instruments. Currently, the instruments are those issued or guaranteed by the government or the Central Bank of Malaysia. Permissible expenditures are those incurred for *Sharī'ah*-compliant activities only. Separate accounting records and financial statements are prepared for the Islamic and conventional deposit insurance systems.
- iv. To maintain confidence in the financial system, MDIC is required to reimburse insured depositors of a failed IBI quickly, and by law no later than three months from the date of a winding-up order. All losses and expenses incurred by MDIC in meeting its obligations to insured depositors and resolving troubled IBI are to be charged to the Islamic deposit insurance fund. There is no commingling of funds or cross-subsidisation between the Islamic and conventional deposit insurance funds. In the event that funds are insufficient to carry out its mandate, MDIC would have access to government and market funding, which would be structured according to *Sharī'ah* requirements.
- v. 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-*Muḍārabah* deposits are given priority over *Muḍārabah* deposits.

It is acknowledged that the implementation of an Islamic deposit insurance system in Malaysia is still a work in progress and may not be readily accepted by all. It has not been stress-tested, and the current systems, policies and processes need to be continuously improved. There are, and will remain, some questions as to the coverage of Islamic deposits until the system has gathered sufficient experience. But it should be noted that any successful deposit insurance programme must protect the majority of depositors.

## **5.0 Issues in the development and implementation of an Islamic deposit insurance system**

With the increasing number of countries introducing Islamic banking, the importance of Islamic deposit insurance has started to be recognised. While there are common issues faced by both conventional deposit insurance and Islamic deposit insurance, this paper will only focus on issues faced by Islamic deposit insurance. The issues are not only encountered by Malaysia, but also by countries that implement the system and those that are contemplating implementing one but cannot do so due to the ensuing issues. Governance, *Sharī'ah*, legal and regulatory issues are the main areas of concern.

### ***i. Lack of Sharī'ah guidance to ensure Sharī'ah compliance***

When Malaysia developed its Islamic deposit insurance system, the only available reference was the guidance papers on the conventional deposit insurance system. Consequently, further assessments were required to determine whether the practices taken from conventional deposit insurance were in compliance with *Sharī'ah* principles. Furthermore, due to the lack of guidance on Islamic deposit insurance, the search for solutions to *Sharī'ah* issues prolonged the process of designing an Islamic deposit insurance system.

Proper *Sharī'ah* governance must be put in place to ensure that the operations of an Islamic deposit insurance system comply with the *Sharī'ah* principles. There is a need to have a *Sharī'ah* body or an expert who can advise the board of directors and the management on issues related to *Sharī'ah*. The management must develop relevant policies and procedures to support the operations of the system as well as the process to validate and monitor *Sharī'ah* compliance matters.

The scarcity of human capital talent and *Sharī'ah* experts to support the system creates pressure to have proper *Sharī'ah* governance. Since Islamic deposit insurance is a relatively new system, countries that have implemented it are still developing such resources.

### ***ii. Permissibility of protecting PSIA***

The issue of protecting PSIA under Islamic deposit insurance is a constant topic of discussion in the Islamic financial community, which has apparently misunderstood the concept of protection of this product by MDIC.

PSIA is an account based on the *Muḍārabah*, or profit-sharing, principle. Under PSIA, account holders (investors) place their funds with an IBI (entrepreneur) who shall utilise

the funds in appropriate ventures. Any profits arising from the ventures shall be distributed to the account holders and IBI based on a pre-agreed profit-sharing ratio. Under the *Muḍārabah* principle, however, any losses from the ventures must be borne solely by the account holders, except in the event of negligence or mismanagement by IBI, where the IBI and not the PSIA holder shall bear the loss.

Based on this premise, some have argued that PSIA holders should not enjoy a guarantee, because guaranteeing *Muḍārabah* capital contradicts the very essence of a *Muḍārabah* contract which does not allow the entrepreneur to protect the PSIA holder. However, a third party guarantee is allowed and, in the case of Malaysia, the guarantor of PSIA is actually MDIC, who will act as the third party to the *Muḍārabah* contract between the PSIA account holder and the IBI. MDIC also guarantees PSIA (i.e. protects the current value of PSIA and not its principal) in the event of an IBI's failure and not during the normal course of business. Furthermore, given that PSIA is a major deposit segment in the financial system, providing protection will contribute to the stability of the Islamic financial system.

**iii.      *Lack of Sharī'ah-compliant investment tools***

There are also insufficient *Sharī'ah*-compliant investment tools to manage and invest funds that are collected on an ex-ante basis. Islamic deposit insurers face difficulties in investing surplus deposit insurance funds, as Islamic instruments are limited. Currently in Malaysia, the investments are restricted to Islamic papers issued by the Government of Malaysia and the Central Bank of Malaysia.

**iv.      *Definition of PSIA***

Opinion has been divided across different jurisdictions on the correct definition of PSIA. In countries where PSIA is treated as a deposit, it will be protected by deposit insurance; however, in the event that PSIA is defined as an investment product, deposit insurance protection may not be given.

There is also a view that the PSIA holders should bear their own account risks, similar to investors in a collective investment scheme. According to this opinion, providing insurance coverage for PSIA holders conflicts with the risk-bearing characteristics of the investment contracts and this can lead to the creation of an uneven playing field between investors in an institution offering Islamic financial services and investors in a collective investment scheme. Further, protecting PSIA can lead to an unequal regulatory treatment between investors in IBI and other investors in the investment and

securities market sector. This may create a potential regulatory arbitrage, as the former is provided with a financial guarantee whereas the latter is not.

Some countries provide protection to both unrestricted and restricted PSIA holders, and some only provide protection to unrestricted PSIA. Generally, under an unrestricted account, the account holders authorise the IBI to invest their funds without imposing any restrictions, and IBI invests them in a pooled portfolio. Under the restricted account, however, account holders authorise IBI to invest their funds with certain restrictions imposed as to where, how and for what purpose they are invested.

In Malaysia, both unrestricted and restricted PSIA are protected by deposit insurance, while Indonesia protects only unrestricted accounts as these account holders behave like depositors (rather than investors). In addition, PSIA constitutes a large portion of the Islamic banking industry and providing protection to PSIA will contribute to the stability of the financial system.

**v. *Sufficiency and enforceability of the legal and regulatory framework for an Islamic deposit insurance system***

An issue that needs to be addressed in developing and implementing an effective Islamic deposit insurance system is that relating to the sufficiency and enforceability of the legal and regulatory framework. Many countries have admitted that this area is one of the main concerns that needs to be addressed before an efficient Islamic deposit insurance system becomes a reality. Due to the shortage of skilled experts in Islamic finance, coupled with the unique features of Islamic finance, it is challenging to come up with a robust legal and regulatory framework that is in line with the *Shari'ah* requirements. Thus, it is anticipated that developing a comprehensive legal and regulatory framework will further hamper the implementation of an Islamic deposit insurance system in various jurisdictions.

**vi. *Insolvency law and policy for intervention and resolution***

Given the unique structure of the operations of IBIs that have different types of PSIAs, there is a need to have solvency laws, policies and procedures for intervention and resolution of IBIs in dealing with the disposal of assets and the distribution of proceeds from the liquidated assets to the liabilities of troubled or insolvent IBIs. The disposal of assets should take into account the existence of both restricted and unrestricted PSIA, which may require separate reimbursement approaches.

## 6.0 Conclusion

In conclusion, an effective Islamic deposit insurance system protects insured depositors when an IBI fails, instills confidence among the general public in relation to the safety of their deposits, promotes the stability of the financial system, and preserves the competitiveness of Islamic deposits. The concept of Islamic deposit insurance is relatively new, and continued research and development are necessary in order to address the current issues, challenges and future needs.

Different countries may face different issues and challenges in implementing the system. The best way forward is to bring Islamic deposit insurance practitioners together to share their respective issues and challenges, and discuss ways to address them. In this respect, the International Association of Deposit Insurers has established the Islamic Deposit Insurance Group with the objectives of conducting research work and developing guidance on the Islamic deposit insurance system. The Group also provides a forum for discussion and facilitates the sharing and exchange of expertise and information on Islamic deposit insurance issues. Currently, the Group has issued the results of a survey on the Islamic deposit insurance system and a discussion paper entitled "*Deposit Insurance from Shariah Perspective*". More discussion papers will be issued in the future.





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Md Khairuddin bin Hj Arshad was appointed the Chief Operating Officer at the beginning of 2010 and he assists the CEO in managing the day-to-day operations of the Corporation. Prior to this appointment, he was the General Manager, Insurance, Risk Assessment and Monitoring Division, responsible for analysis and monitoring of the risk level of banks as well as the intervention and failure resolutions of troubled banks.

Khairuddin also served Bank Negara Malaysia (BNM) for over 15 years in the Bank Regulation Department and the Islamic Banking and Takaful Department. He has extensive experience in Islamic banking and finance, and is currently the Chairman of the Islamic Deposit Insurance Group (IDIG) of IADI and an observer of the Malaysian Accounting Standards Board (MASB) working group on Islamic financial transactions. He has also provided technical assistance to various countries in developing their Islamic banking industry as well as presented papers at domestic and international seminars. He holds an accounting degree from the International Islamic University, Malaysia.





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