

5th SEMINAR ON ISLAMIC DEPOSIT INSURANCE

**“Essential Elements for Effective Islamic Deposit Insurance Systems:
Shariah Governance, Sources and Management of Funds”**

22 – 23 October 2015 | Kuala Lumpur, Malaysia



Perbadanan Insurans Deposit Malaysia
Protecting Your Insurance And Deposits In Malaysia



Islamic Deposit Insurance Fund

**Jumana Hamed, Director General
Jordan Deposit Insurance Corporation (JODIC)**

5th Seminar on Islamic Deposit Insurance

**“Essential Elements for Effective Islamic Deposit Insurance Systems:
Shariah Governance, Sources and Management of Funds”**



Islamic Deposit Insurance Fund

- Introduction
- Design Features of Islamic Deposit Insurance Fund
- Types of Islamic Accounts
- Islamic Deposit Insurance Permissibility Concepts
- Fund Contributions
- Emergency Funding
- Use of Funds
- Target Fund Size
- Management of Islamic Fund
- Priority of Claims
- Challenges Ahead



Introduction: Islamic Finance

- Islamic finance has grown at a remarkable pace over the last 10 years:
 - ✓ Islamic banking assets grew at an annual rate of 17.6% between 2009-2013.
 - ✓ It is estimated to grow at an average rate of 19.7% a year till the year 2018.
 - ✓ Islamic banking total assets reached more than 2 trillion in 2015, a trend that is expected to top up to more than 3 trillion in 2020.



Introduction: Islamic Deposit Insurance

- The rapid developments in the Islamic banking industry in many jurisdictions has called to protect Islamic deposits by establishing explicit Islamic deposit insurance system.
- Islamic deposit insurance systems aim to safeguard depositors through insuring their deposits in accordance with Islamic principles and rules to:
 - i. Enhance public confidence.
 - ii. Provide equitable treatment with depositors at conventional banks.
 - iii. Promote competitiveness of Islamic deposits vis-à-vis conventional deposits.
 - iv. Support financial stability.



Introduction: Islamic Deposit Insurance/ Cont'd

Three Models of Islamic Deposit Insurance:

- ✓ Insuring Islamic deposits under conventional deposit insurance system.
- ✓ Insuring Islamic deposits separately from conventional deposit insurance system.
- ✓ A fully fledged Islamic deposit insurance system.



Introduction: Islamic Deposit Insurance/ Cont'd

- The essential step to establish an IDIS is to issue the Fatwa, or legal interpretation that views the permissibility of deposit insurance from Shari'ah perspective.
- Good Shari'ah governance must be put in place to ensure that operations of an IDIS comply with Shari'ah principles.
- Shari'ah experts advice is needed for issues related to Shari'ah rulings and to monitor compliance of deposit insurance scheme operations.



Design Features of Islamic Deposit Insurance Fund (IDIF)

- Sound funding arrangements are critical to the design and operational features of an effective Islamic deposit insurance system to:
 - ✓ Achieve its public policy objectives.
 - ✓ Maintain public confidence.
 - ✓ Promote financial stability, and
 - ✓ Not violate Shari'ah principles.



Design Features of IDIF/Cont'd

- To preserve credibility and to fulfill its mandate effectively, IDIS should establish an efficient and adequate fund to reimburse depositors in the event of an Islamic bank failure.
- The Islamic deposit insurance fund needs to take into consideration Shari'ah perspective to:
 - i. Draw the mechanisms of funding resources.
 - ii. Manage the fund according to Islamic jurisprudence.



Types of Islamic Accounts vis-à-vis Conventional Accounts

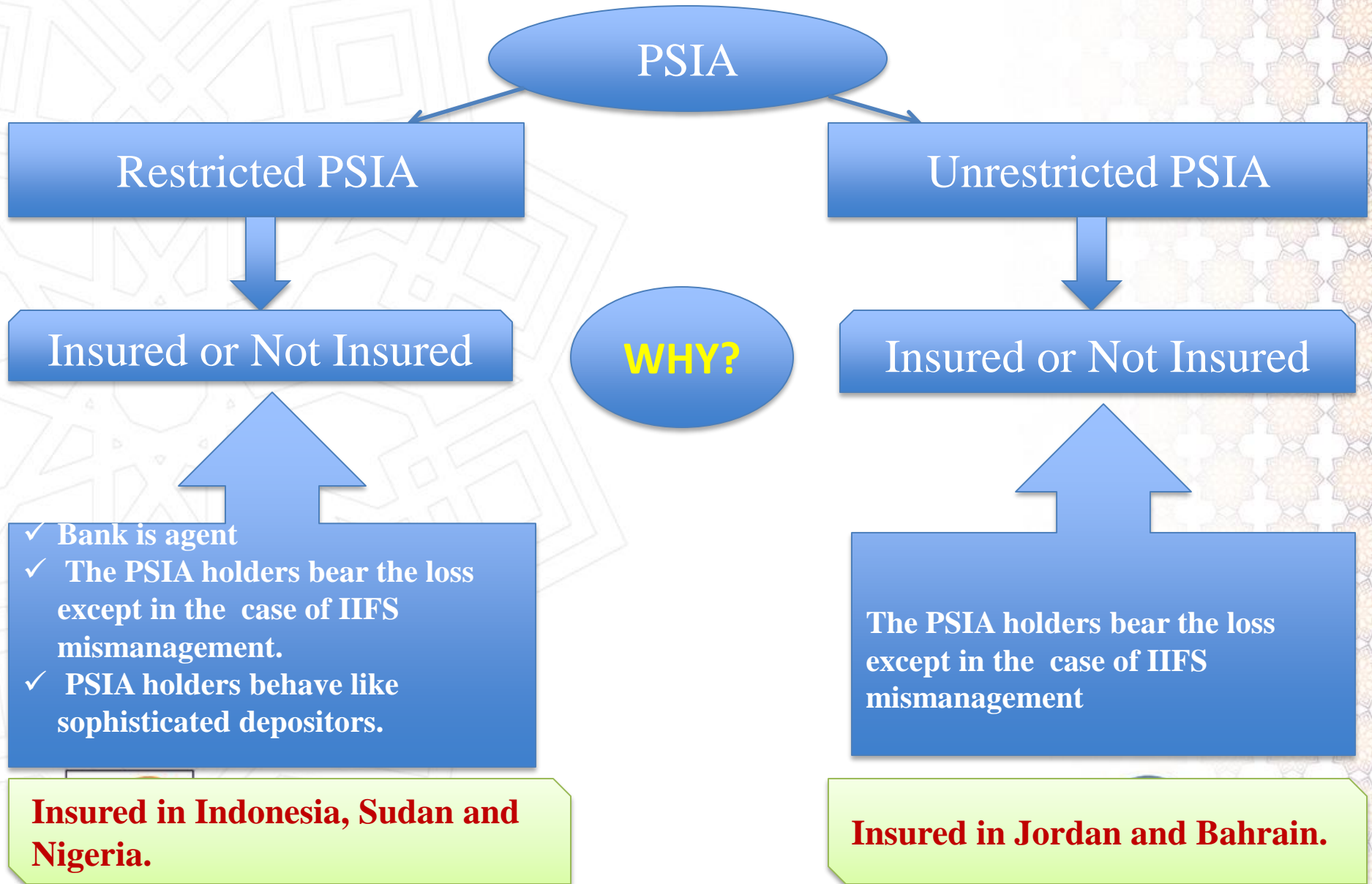
Islamic	Conventional
<ul style="list-style-type: none"> ➤ Islamic Deposits <ul style="list-style-type: none"> ✓ Wadi'ah ✓ Qard 	<ul style="list-style-type: none"> ➤ Demand Deposits
<ul style="list-style-type: none"> ➤ Investments Accounts <ul style="list-style-type: none"> ✓ Mudarabah (Reverse) ✓ Wakalah 	<ul style="list-style-type: none"> ➤ Saving Deposits
	<ul style="list-style-type: none"> ➤ Time Deposits

Types of Islamic Accounts vis-à-vis Conventional Accounts/ Cont'd

- Wadi'ah and Qard deposits are trust deposits that carry with them a full guarantee by the IIFS and they are placed at the bank on the condition of being withdrawn upon demand.
- Investments accounts: Form the bulk of ID, profit sharing investment accounts (PSIA) do not allow the guarantee neither for the capital (principal) nor return (profits); (sharing profit / bearing the loss).



Profit Sharing Investment Accounts



IDI Permissibility Concepts

Two Modalities:

1- Takaful and Tawun based IDI:

- ✓ Involves the solidarity among Islamic banks for the Islamic deposits accounts “Qard and Wadi’ah” on one side, and
- ✓ Takaful or solidarity among investors themselves for investment accounts on the other side.

This model is adopted by Sudan and Jordan.

2- Kafalah bil ujr (agency with fee) Model:

- ✓ Under this contract (kafalah bi al ujr) a relationship between an IIFS, as guaranteed party, and the deposit insurer, as guarantor is being created.
- ✓ The IIFS pays a fee to the deposit insurer and, in the event that the IIFS fails, the deposit insurer will assume the obligation of reimbursing insured depositors.

This model is adopted by Malaysia and Nigeria.



Fund Contributions

- Funding for Islamic deposit insurance system is to be provided either on *ex-ante* or *ex-post* basis where international best practices call for *ex-ante* funding.

In Takaful Case:

- Contribution fees shall be borne by the *Islamic banks* for Islamic deposits alongside with the un-invested portion of the investment accounts.
- Contribution fees shall be borne by the *investors themselves* for the PSIA in their capacity as the owners of the investment accounts.
- Premiums paid are considered on (Tabarru) or donation basis. The participants thus will have no access to paid sums.

In Kafala bil ujr Case:

- The fee paid by the IIFSs is considered the contribution fees.



Fund Contribution /Cont'd

- The main differences between Takaful model and Kafalah bil ujr model:

	Takaful	Kafala bi l ujr
Agreement	Between the participants	Between an IIFS and the DIC
Contributors	All participants (IIFS and Investors)	IIFS pays a guarantee fee to the DIC
Owner	Belongs to the participants	Belongs to the DIC
Reimbursement	Takaful funds	Deposit insurer's fund



Fund Contributions/ Cont'd

- Under Sudan and Jordan's Takaful concepts:
 - ✓ Participants' contributions are maintained in two **separate** Takaful funds (two portfolios):
 - i. One for the guarantee of Islamic deposits, and
 - ii. The other for the guarantee of all investment accounts (PSIA) in Sudan and the unrestricted portion of the PSIA in Jordan.



Fund Contribution/ Cont'd

➤ Seed Funding:

- ✓ IDIF can be augmented by a seed contribution by the Government or any public party (entity).

➤ Premium fees

- ✓ All Jurisdictions levy equal premium rates for Islamic and conventional banks.
- ✓ Levying premiums on ex-ante mechanism is paid either on annually or quarterly basis.



Fund Contributions/ Cont'd

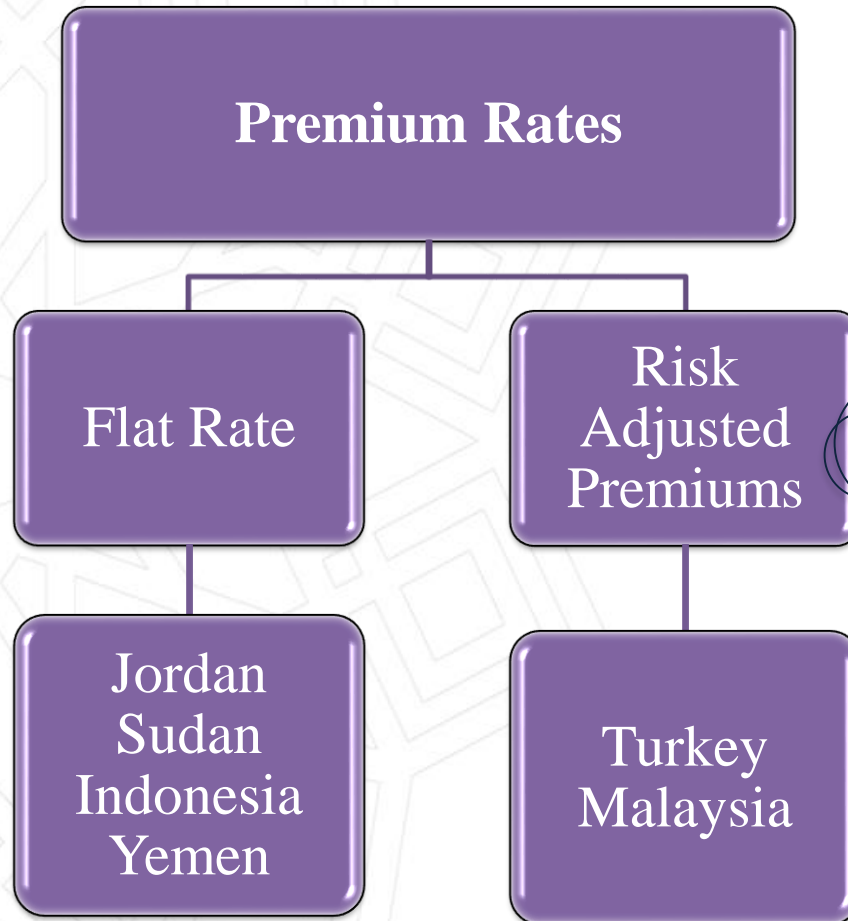
The mechanism for the assessment and collection of premiums should be clearly defined.

Assessment Base:

<p>Total covered deposits</p>	<p>Eligible deposits</p>	<p>Annual average of the insured deposits</p>	<p>Total deposits</p>
<ul style="list-style-type: none"> •Turkey •Malaysia •Yemen 	<ul style="list-style-type: none"> •Jordan 	<ul style="list-style-type: none"> •Sudan 	<ul style="list-style-type: none"> •Indonesia



Fund Contributions/ Cont'd



The Risk adjusted premium poses a problem for the Takaful fund as some scholars debate levying different rates on participants cooperating in the same fund

Emergency Funding

- In event of insufficient IDIF to reimburse depositors promptly, a deposit insurer would be in need to access additional or back up funding either form government or market.
- All funding mechanisms have to be Shari'ah compliant. (i.e.with no interests, which means either benevolent loan or issuing Sukuk).
- Liquidity funding should be pre-arranged so that such funds can be accessed by a deposit insurer in a timely manner to fulfill its mandate.



Emergency Funding/ Cont'd

- Most jurisdictions have a legal arranged source of back up funding:

Jurisdiction	Sources of Back up Funding	Method of Borrowing
Jordan	Conventional Fund (Qard Hasan) and Market	Benevolent Loan (Qard Hasan)
Turkey	Government, Market and Conventional Fund	Traditional Loan and Sukuk
Malaysia	Government and Market	Sukuk
Sudan	Government	Benevolent Loan
Yemen	Government	Traditional Loan

Emergency Funding/ Cont'd

Sources of Back Up Funding

Government

Market

Conventional Fund

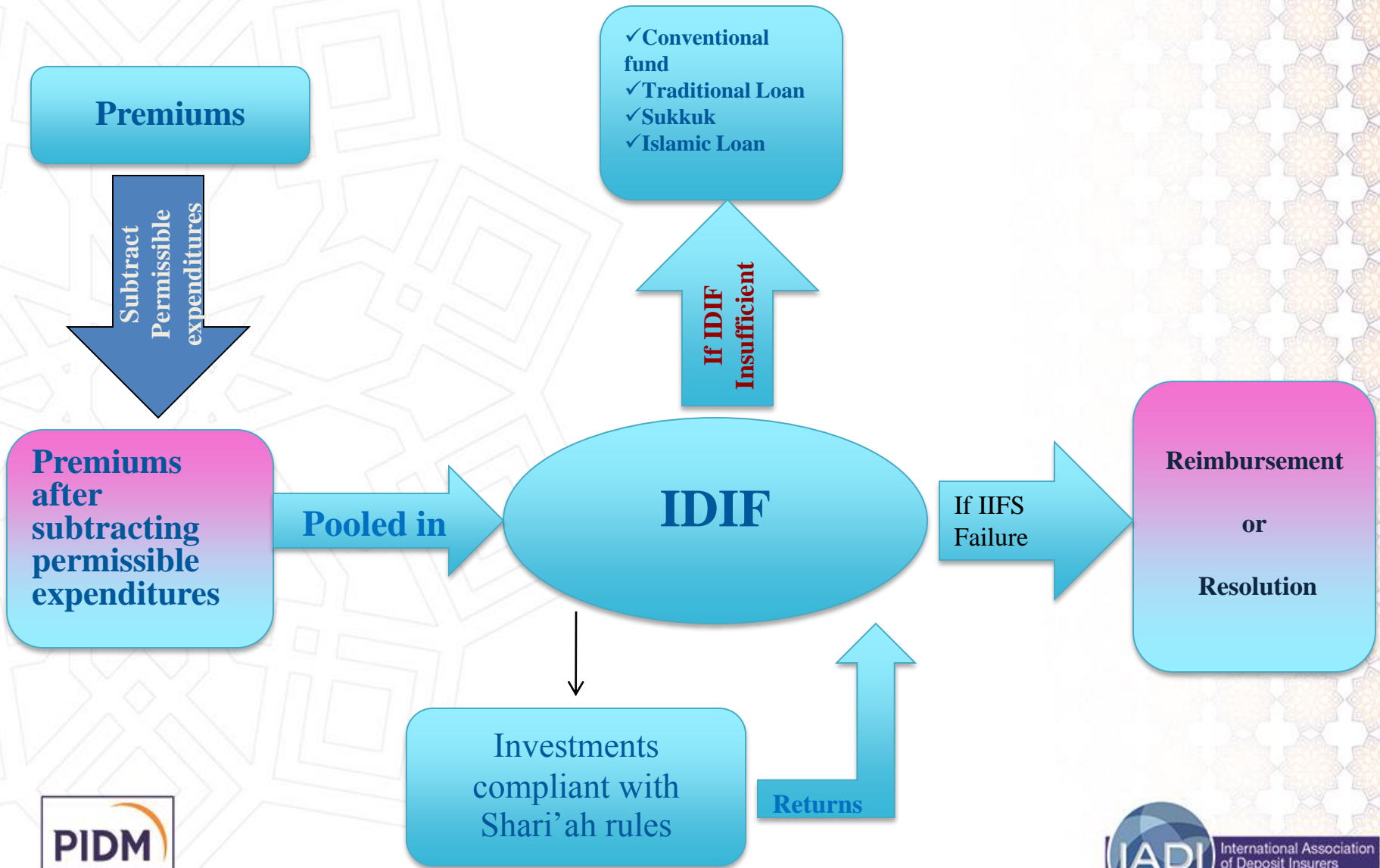
Emergency backup funding poses quite a problem for an IDIS because of the impermissibility of using interest-bearing instruments.

The end result is that tax payers are subsidizing Islamic depositors

Issuing Sukuk needs considerable time

The end result is that conventional fund is subsidizing Islamic fund

Uses of Funds



Target Fund Size

- Islamic deposit insurance fund should be large enough to reduce the probability of the IDIF's insolvency to an acceptable level.
- Target of Islamic fund size can be determined either by the Law as in Jordan or the Board of Directors like Sudan or internally by the DIS itself like Malaysia.
- Target fund size is the same in all jurisdictions for Islamic and conventional funds. *This raises an issue of should the Islamic fund target a higher ratio due to the emergency funding issue?*



Management of IDIF

- The IDIF should be managed and invested in compliance with Shari'ah principles.
- The IDIF should be segregated and administered separately and independently from the conventional deposit insurance fund (accounting records and financial statements).
- The fund's reserves shall be invested in Shari'ah compliant issued and risk free instruments such as Sukuk issued or guaranteed by the Government.
- Expenses are attributed to both the IDIF and the conventional fund are charged on pro rata basis.



Management of Fund/ Cont'd

- Jordan and Sudan manage the IDIF on the basis of wakalah bil ujr (Agency with fee) arrangement. **Thus, in case of IDIF liquidation:**
 - Jordan: the remaining balance will be transferred to the Zakat Fund after covering all losses and expenses incurred by the IDIF.
 - Sudan: IDIF will be transferred to BDSF.
 - In Malaysia the fund is owned by MDIC .

- **In Jordan only:** A Shari'ah scholar should be appointed by JODIC for a term of two years (renewable) to ensure that all fund arrangements and operations are compliant with Shari'ah rules and principles.



Priority of Claims

- Similar to the conventional fund, the ID insurer has the legal right to recover his expenditures for insured deposits repayment from liquidation of the assets of the failed bank.
- By virtue of insured deposit payment, the DIS should be subrogated to the insured depositors' preferred claims on the failed bank's receivership estate.
- The claims of the ID insurer enjoy a very high priority, after secured creditors (but only up to the value of the collateral) and the receiver's administrative expenses.



Priority of Claims/ Cont'd

❖ In Jordan, the priority of claims is as follows:

1. The benevolent loans obtained after the issuance of the liquidation decision to complete the liquidation proceedings.
2. The expenses and other expenditures incurred by the liquidator .
3. The rights of employees and workers.
4. The benevolent loans that the IIFS under liquidation obtained from the central bank before the issuance of liquidation decision.
5. The benevolent loans that the IIFS under liquidation obtained from other banks with the approval of the central bank during the six months prior to the issuance of the liquidation decision.
6. The rights of Islamic deposits holders and the rights of IDIF stemming from its insuring eligible deposits and investment accounts.
7. The rights of other creditors.
8. The remaining rights of investment account holders.
9. Any taxes and fees owed to the Government.
10. The rights of shareholders.



Challenges Ahead

➤ **Shari'ah Issues:**

The concept of IDI is relatively new and still evolving. Only a few jurisdictions have set up an IDIS. Those who have an IDIS in place follow different operational models due to:

- ✓ Differences in their IIFS specificities .
- ✓ Different interpretations of Shari'ah views on financial matters across various jurisdiction.
- ✓ Lack of guiding principles in Shari'ah perspective.
- ✓ Lack of human resources expertise in this field.

➤ **Investment Tools:**

Limitations of appropriate Shari'ah compliant instruments for IDIS to invest in.



Challenges Ahead/ Cont'd

➤ **Back up Funding Issues:**

Interest-based instruments are not acceptable for emergency funding. Benevolent loans from Government or conventional fund will be considered subsidization from tax payers and depositors at conventional banks consecutively. Issuing sukuk needs plenty of time.

Is a higher target rate needed for Islamic fund?

➤ **Adopting a Risk Based Premium Rate:**

In Takaful based model, imposing unequal premiums on investors participating in the same fund is debatable.



Thank You

