

## KEY POINTS

- The financial crisis highlighted the need for deposit insurance regimes that effectively protect depositors and promote financial stability.
- Interest in Islamic deposit insurance is growing, spurred by the growth of Islamic banking, local plans to develop stable financial sectors, and Basel III.
- Well-developed Islamic deposit insurance schemes will be Shari'ah-compliant, tailored for local environments, and consistent with international effective deposit insurance standards.
- Risk-based deposit insurance premiums are preferable, to promote good governance and deter moral hazard, including by avoiding the subsidisation of risky banks by stable banks. Shari'ah-compliant models that allow risk-based premiums should be considered.

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# Deposit insurance frameworks for Islamic banks: design and policy considerations

This article considers models for Islamic bank deposit insurance, including how they should be funded and whether premia should be assessed on the basis of risk or a flat-rate applied.

The financial crisis underscored the importance of effective deposit insurance regimes to financial sector strength and systemic stability. A 2008 report of the G-20 Financial Stability Forum (FSF) (now the Financial Stability Board) “stressed the need for authorities to agree on an international set of principles for effective deposit insurance systems”.<sup>1</sup> Subsequently, the Basel Committee on Banking Supervision (BCBS) and the International Association of Deposit Insurers (IADI) jointly produced Core Principles for Effective Deposit Insurance Systems, which set forth key characteristics of, and measures for assessing, deposit insurance systems.<sup>2</sup>

Noting the rapid growth of Islamic banking and other financial services, the IADI Core Principles for Effective Deposit Insurance Systems, November 2014, 15-16 (the “Core Principles”), recognise the need to establish “Islamic deposit insurance systems... for the protection of Islamic deposits in accordance with Islamic principles and rules”. (The Core Principles contemplate not just deposit insurance schemes that apply to deposits with Islamic banks, eg frameworks that cover both conventional and Islamic deposits, eg Turkey, but deposit insurance systems that are themselves established and operate in accordance with Islamic rules and standards eg Sudan.)

In jurisdictions with significant Islamic banking presence, the need for effective Islamic banking regulatory frameworks – including safety nets – may be assuming greater urgency: to conform to post-crisis international banking standards; gain positioning as reputable financial markets; and/or capitalise on demand for Islamic

banking and other financial services. Plans for Islamic deposit insurance systems motivated by these goals are shown in the box. Design and policy considerations that will and should arise in developing Islamic deposit insurance are discussed below.

## CONFORMANCE TO EFFECTIVE DEPOSIT INSURANCE SYSTEM STANDARDS

Islamic deposit insurance schemes will need to conform to international standards reflected in the Core Principles.

### ISLAMIC DEPOSIT INSURANCE: RECENT EFFORTS, PLANS

In 2014, the Indonesia Deposit Insurance Corporation announced plans to create a separate deposit insurance framework for Islamic bank deposits, including to ameliorate the potential adverse consequences for Islamic banks under Basel III (eg to quality as “stable” deposits under Basel’s Liquidity Coverage Ratio (the “Basel LCR”) framework, retail demand deposits must, *inter alia*, be covered up to specific numerical coverage limits by explicit, *ex ante*, deposit insurance schemes).<sup>5</sup>

In 2013, Qatar’s Central Bank (QCB), Financial Centre Regulatory Authority, and Financial Markets Authority unveiled a strategic plan to build “a resilient financial sector... that operates at the highest standards of regulation and supervision,” and includes an explicit deposit protection regime.<sup>6</sup> Qatar may consider, “at a later stage,” risk-based deposit insurance premiums, as well as an Islamic framework (*takaful*-based), “as a consequence of the increasing scale of operations of the Islamic banking sector” in Qatar.<sup>7</sup>

Jordan was, as of November 2014, amending its law to establish an Islamic deposit insurance framework, to operate alongside its existing conventional system (IADI, *Shari’ah Approaches for the Implementation of Islamic Deposit Insurance Systems*, Discussion Paper, November 2014, 6) (the “IADI Shari’ah Approaches”).<sup>8</sup> Under Jordan’s existing deposit insurance framework, established in 2000, conventional banks are required to participate; Islamic banks may do so voluntarily (reportedly no Islamic bank has participated (as of November 2014)). Participation in the new Islamic scheme will be mandatory for Islamic banks.<sup>9</sup> According to the IADI, 19% of total deposits Jordan’s banking system are with Islamic banks<sup>10</sup> (assuming that the 19% figure reflected late 2014 figures).

## Feature

The Core Principles expect that deposit insurers be constituted and empowered appropriately for the economic, financial market, and legal and regulatory environments in which they operate.<sup>3</sup> As well, they enumerate some of the essential characteristics of a well-constituted deposit insurer, including that it have: clear legal character (eg an agency of government) and mandate; authority and independence needed to effectively carry out its functions; accountability to a higher authority; sufficient funding from clearly defined funding sources, at inception and continually; ability to promptly determine and pay claims; qualified staff and management; and, legal protection from claims arising out of actions taken within its scope of authority.<sup>4</sup> These essential characteristics of an effective deposit insurer can be readily incorporated into an Islamic deposit insurance system.

“The insurance fund is funded by Islamic banks which contribute their own funds to cover deposit... and savings accounts... and investment accounts.”

### ISLAMIC LEGAL, OPERATING MODEL

Shari’ah scholars have disapproved of the deposit insurance model – arguing that, *inter alia*, it entails (like conventional insurance) excessive uncertainty (*gharar*), as the insured risk might not materialise. As to Islamic models, opinions differ as to legal and operational models, as illustrated by the Islamic deposit insurance models of Sudan and Malaysia, some of the salient features of which are discussed here.

#### Sudan

Sudan’s banking system is wholly Islamic, as is, naturally, its deposit insurance scheme that is administered by the Bank Deposit Security Fund (BDSF).<sup>11</sup> Sudan’s deposit insurance model is based on *takaful* (an Islamic mutual or solidarity model) and was approved by its central bank-housed Shari’ah

High Advisory Board.<sup>12</sup> Participation is mandatory for domestic banks and branches of foreign banks.<sup>13</sup> The BDSF maintains two deposit coverage *takaful* funds that enjoy separate legal status – one covers demand deposits and savings accounts; the other covers non-capital guaranteed investment accounts (Profit Sharing Investment Accounts, discussed below).<sup>14</sup> Premium payments are in the form of voluntary contributions (*tabarru*), backed by participants’ mutual commitment (*ta’awun*) to contribute to the respective funds (the voluntary nature of contributions diminishes the objectionable element of uncertainty (*gharar*) entailed in other deposit protection schemes).<sup>15</sup> Islamic banks, the Central Bank and the Ministry of Finance contribute to the fund for deposit and savings accounts.<sup>16</sup> The Central Bank, the Ministry of Finance and investment account holders contribute to the investment account fund; Sudan’s

Shari’ah High Advisory Board ruled that Islamic Banks may not underwrite the risk of investment account loss for which account holders are responsible, given the Shari’ah-based allocation of risk to account holders.<sup>17</sup> The BDSF is paid a fee for managing the *takaful* funds, under an agency with fee (*wakalah bil ujr*) arrangement, and the deposit *takaful* funds are owned by their respective contributors.<sup>18</sup>

#### Malaysia

Malaysia operates a dual deposit insurance framework that is managed by the Malaysia Deposit Insurance Corporation (MDIC) and covers, through separately funded, maintained, and segregated conventional and Islamic funds, covered deposits held by conventional and Islamic banks (eg MDIC, *Note of Perbadanan Insurans Deposit Malaysia on Islamic*

*Deposit Insurance*, 12 October 2009) (the “MDIC Note”). The MDIC is, pursuant to a *kafalah bil ujr* (guarantee for fee) structure, a guarantor (*kafil*) of Islamic banks’ obligations vis-à-vis eligible bank deposits (up to coverage limits and subject to priority of claims rules). In exchange, the MDIC receives from Islamic banks a fee (*ujr*) in the form of annual premiums.<sup>19</sup> The insurance fund is funded by Islamic banks (which contribute their own funds to cover deposit (demand) and savings accounts, and, on behalf of investment account holders, funds to cover investment accounts). The funds are owned by the MDIC.<sup>20</sup> Under the MDIC’s priority rules, deposit (demand) and savings accounts take priority over investment accounts; the rationale for the priority rules is that Islamic banks are not responsible to investment account holders for capital and uncredited profit losses.<sup>21</sup> The fee character of the premiums paid by banks to the MDIC is important, as it allows the MDIC to assess risk-based premiums.

As the MDIC has acknowledged, the *kafalah bil ujr* structure has been disapproved by “a number of the classical scholars”<sup>22</sup>; however, Malaysia’s Shari’ah Advisory Council (the country’s central-bank housed Shari’ah Board) and others have approved the arrangement on public policy and technical legal grounds.<sup>23</sup>

Under both the Malaysian and Sudanese systems, deposit coverage fund surpluses are invested only in Shari’ah-compliant instruments and deficits in funding are compensated via Shari’ah-compliant sources, whether from the government, the market, or Shari’ah-compliant borrowing from respective deposit coverage funds managed by the deposit insurer.<sup>24</sup>

### Treatment of Profit Sharing Investment Accounts

A key question that arises in the context of Islamic deposit insurance, as well in connection with other legal, regulatory, and governance issues, is how Profit Sharing Investment Accounts (PSIAs)

should be treated. PSIA's are non-capital guaranteed, profit and loss sharing investment products that frequently are based on a form of Islamic partnership between an Islamic bank and the account holder. PSIA's can be restricted, where the customer directs or limits the banks' investment authority (eg by limiting the kinds of assets in which to invest), or unrestricted, where the customer places no similar limitations on the bank's investment conduct.<sup>25</sup>

Given the risk of loss borne by the PSIA holder, clear questions arise as to PSIA's insurability under Shari'ah and the prudence of providing safety nets for a product that allocates risk of loss to the customer and is contracted for with full customer knowledge (it is hoped). These questions must be answered in accordance with Shari'ah and consider not only blackletter law, but also Islamic legal and policy imperatives that require transparency and integrity in the market (as evidenced also by historical practice), with appropriate calibration for modern Islamic banking.<sup>26</sup>

Sudan and Malaysia's deposit protection frameworks strike (in different ways and to different degrees) a balance between Shari'ah-based PSIA risk allocations and the public interest in protecting PSIA holders. However, those responsible for developing future Islamic deposit protection systems will be well served to scrutinise PSIA coverage approaches (or no coverage of PSIA's) in light of the manner in which PSIA's are commonly managed in their jurisdictions, as well as related regulatory treatment and oversight.

### SCOPE OF MANDATE; ACCOMMODATE OR COMPENSATE FOR SYSTEMIC DEFICIENCIES?

As the Core Principles explain, and global surveys bear out, deposit insurers' mandates range from the perfunctory (eg "pay box," responsible only for payment of funds in the event of bank inability to pay) to "loss minimizer" (responsible for identifying and selecting "least-cost resolution strategies") to "risk minimizer" (comprehensive risk reduction and

mitigation functions, and commensurate powers of, eg assessment, oversight, and intervention and resolution).<sup>27</sup>

In the context of Islamic banking and the jurisdictions in which Islamic banks operate, the relative degree of financial sector maturity (conventional and Islamic) and the strength of legal, regulatory, and enforcement regimes should inform choices as to the nature and degree of deposit insurer mandates. Where market and legal norms and rules are still developing, regulation is insufficient, and/or enforcement is weak or enforcement culture is still taking shape, authorities can choose to limit the mandate of the deposit insurer to accommodate current structural deficiencies, or empower the deposit insurer to compensate for deficiencies. Empowerment is preferable to establish or enhance a jurisdiction's credibility, and may also yield experience and market insight on which to build additional market and regulatory infrastructure.

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### EX ANTE FUNDING

Most explicit insurance schemes are funded *ex ante*, rather than *ex post* (funds collected from banks following a covered bank's failure). The Core Principles include *ex ante* funding among the "essential criteria" for effective deposit insurance systems.<sup>28</sup> As noted above, under the Basel III LCR, national authorities may treat retail deposits as "stable" only if they are, *inter alia*, covered by a "prefunded" deposit insurance scheme.<sup>29</sup> Not only does *ex ante* funding make the sufficiency and timely availability of funds more likely when needed, an *ex ante* regime lends credibility to the insurer from the consumer perspective and, importantly, bolsters the seriousness of the insurer and its mandate in the eyes of covered banks. An *ex ante* funding arrangement is particularly well-

sued to jurisdictions that lack strong financial services legal, regulatory, and enforcement cultures.

### RISK-BASED PREMIUM

Risk-based premiums, properly applied, reflect the risks posed by specific banks, lines of business, or other factors. As well, they provide the deposit insurer (and relevant authorities) with a practical tool for promoting healthy practices by attaching clear, entity-specific financial rewards and costs that do not accrue in flat-rate premium systems that subsidise risky banks at the expense of prudent banks. Where financial sector stability is a priority, and particularly where other regulatory tools are insufficient, the risk-based premium approach is preferable, so long as the insurer is equipped to carry out its functions and assesses risk according to rules and procedures that are clear and uniformly enforced.

Of course, the Shari'ah-permissibility and mechanics of a risk-based premium

approach would need to be determined in advance by competent authorities (preferably not Shari'ah scholars that serve in their private capacities on the Shari'ah Supervisory Boards (SSBs) of covered banks, in jurisdictions in which no national Shari'ah board or similar body is constituted). As discussed above, the Malaysian guarantee for fee (*kafalah bil ujr*) system permits risk-based premiums. However, as the *kafalah bil ujr* structure is unlikely to be embraced widely (in the Middle East particularly), alternative Islamic frameworks that allow risk-based premiums should be explored.

### SHARI'AH GOVERNANCE AND COMPLIANCE

As Shari'ah-compliance is obviously the lifeblood of Islamic banking, national authorities may consider whether an Islamic

## Feature

### Biog box

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bank's compliance with applicable Shari'ah standards – as determined by its SSB, a national Shari'ah board, and/or as derived from generally accepted Shari'ah rules and standards in the jurisdiction – should be among the factors considered in assessing entity risk and calculating risk-based premiums (if allowed). In this area, the composition of an individual bank's SSB may be relevant. For example, Islamic banks can be incentivised to diversify their SSBs by imposing board member term limits to address the real or perceived intellectual entrenchment, conflicts of interest, and time-related practical issues that arise when SSBs are dominated by "brand name" scholars that have been known to serve contemporaneously on multiple SSBs. Where matters such as the composition of SSBs are deemed outside the scope of deposit insurers' mandates (or outside their risk focuses), the same issues can be taken up by other regulators.

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### PUBLIC AWARENESS; ISLAMIC BANKING CAPACITY BUILDING ROLE

Public awareness of deposit insurance regimes is clearly essential – depositors must know of the availability and limitations of deposit protection.<sup>30</sup> And, effective public communication contributes to a culture of rule of law in the financial sector, among both consumers and banks. Moreover, an insurer that communicates effectively can serve in an important industry capacity building role. For example, the Islamic finance industry is underserved where high quality, industry-relevant educational content or other professional development offerings are concerned (particularly at junior and middle personnel levels). An empowered deposit insurer, presumably having valuable and industry-relevant information (excluding the confidential kind, of course), as well as convening power, could contribute to industry

and financial services capacity building. (Sources of funding for such activities, eg government, surplus insurance funds, if accessible for such purposes, would need to be determined.)

### A BALANCING ACT

The discussion above covers only a few of the Shari'ah, civil law, and policy issues that authorities will need to address in developing and operating Islamic deposit protection schemes. Authorities will have to balance Islamic mandates, international standards, and practical policy objectives: in doing so, Islamic and compatible conventional policy imperatives for good governance and market integrity should inform their choices. Whatever models are chosen, empowered deposit insurers are preferable, particularly in jurisdictions where legal, regulatory, and enforcement infrastructures are still taking shape. ■

- 13 *Id.* at 7-8.
- 14 *Id.* at 7-9.
- 15 *Id.* at 8-9.
- 16 *Id.* at 7-8.
- 17 *Id.* at 8.
- 18 *Id.*
- 19 MDIC Note at 2-3; IADI *Shari'ah Approaches* at 15.
- 20 IADI *Shari'ah Approaches* at 18.
- 21 *Id.* at 16.
- 22 MDIC Note at 4.
- 23 *Id.* at 4-5.
- 24 IADI *Shari'ah Approaches* at 9, 16.
- 25 Only unrestricted accounts are of concern here; the discussion above of investment account treatment in the Malaysia and Sudan systems dealt only with unrestricted PSiAs. For a detailed discussion of PSiAs and issues that arise in their management, eg Hdeel Abdelhady, "Consumer-oriented insolvency risk allocation in Islamic retail profit sharing investment accounts", [2014] 4 JIBFL 236.
- 26 Eg Hdeel Abdelhady, "Specialized Insolvency Regimes for Islamic Banks: Regulatory Prerogative and Process Design", *World Bank Legal Review*, Vol 5 (2013) at 141-42 (discussing, inter alia, Islamic law and policy-based market regulatory practices).
- 27 Core Principles at 19-20.
- 28 Core Principles at 29.
- 29 Basel III LCR at paras 75-78 (the "presence of deposit insurance alone is not sufficient to consider a deposit "stable" (Id at para 77)).
- 30 Eg Core Principles at 32-33.

### Further reading

- Consumer-orientated insolvency risk allocation in Islamic retail profit sharing investment accounts [2014] 4 JIBFL 236
- Recent trends and new perspectives in global Islamic fixed income capital markets [2014] 11 JIBFL 713
- Lexisnexis Loan Ranger blog: The year in Islamic Finance

- 1 FSF, *Thematic Review on Deposit Insurance Systems*, Peer Review Report, 8 February, 2012, i.
- 2 *Id.*
- 3 Core Principles at 11-15.
- 4 See generally, Core Principles.
- 5 See, eg, BusinessWorld Online, "Indonesia plans Islamic repo rules, separate bank deposit insurance", 3 December 2014; BCBS, *Basel III: The Liquidity Coverage and liquidity risk monitoring tools*, January 2013.
- 6 *Strategic Plan for Financial Sector Regulation*, 4, 28.
- 7 *Id.* at 28.
- 8 IADI, *Shari'ah Approaches for the Implementation of Islamic Deposit Insurance Systems*, Discussion Paper, November 2014, 6.
- 9 *Id.* at 10 & n 7.
- 10 *Id.* at 10.
- 11 *Id.* at 7-10.
- 12 *Id.* at 7.