Knowing Islamic deposit insurance systems

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Islamic Deposit Insurance is a relatively new concept, with the first ex-post IDI scheme reported to have been set up by Bahrain in 1993 while in 1996 Sudan was the first to introduce an ex- ante scheme. IDI is an explicit insurance scheme that is Sharia-compliant and provides protection to depositors against the potential loss in the event of an Islamic bank's failure. It is implemented in countries where Islamic deposits are offered to the public.

There has been transformation of the Islamic financial landscape to turn it into a vibrant, dynamic and competitive global intermediation mechanism.

The industry comprises of more than 300 Islamic financial institutions in over 75 countries, and its assets were estimated to be around US$1,6 trillion globally as at the end of 2012.

The Muslim population is estimated to be one fourth (1.57 billion) of the world's population (6.8 billion in 2009) giving impetus for the Muslim market to grow further.

It is pertinent to note that some IDIs provide their services to non-Islamic clients as well.

Some countries have started to evaluate the possibility of establishing Islamic finance as a potential alternative following the global financial crisis that has seen the collapse of several giant conventional financial institutions.

According to a survey done by International Association of Deposit Insurers, the Islamic financial system, which introduces greater discipline into the economy and links credit expansion to the growth of the real economy, is capable of minimising the severity and frequency of financial crisis. Nevertheless, the guidance on implementing IDI is minimal, if not in-existent, which to a certain extent has dampened its development.

The increase in countries introducing or adopting Islamic banking, resulted in the significance of IDI being recognised.

A number of countries have adopted Islamic finance but a limited number have introduced IDI because of the small size of Islamic deposits compared to total deposits in the overall financial system, or a lack of clarity as to the insurability of profit-sharing investment accounts (PSIAs) which tend to form the bulk of total Islamic funds).

There are two categories of PSIA: restricted and unrestricted. Some countries may not protect holders of the former, as they are regarded as investors (rather than depositors) who understand well the risk/reward relationship of their placement or investment.

This is purported to exert market discipline among the restricted PSIA holders when placing or investing their money. By contrast, holders of unrestricted PSIAs may be protected as they behave like depositors (rather than investors).

The IDI differs from the conventional system in the sense that it is subject to Sharia requirements but both systems have the same objective of protecting depositors and maintaining financial system stability.

In this regard, the system must be free from the elements that Islam strictly prohibits such as interest, uncertainty and gambling.

Examples of countries with Islamic DIS include Sudan, Malaysia, Turkey and Indonesia (IADI Survey on Islamic DIS, March 2010).

In brief there are broadly three models of Islamic deposit insurance, i.e, protecting Islamic deposits under a conventional deposit insurance system, develop a separately IDIS running parallel to a conventional system, and develop a fully-fledged IDIS with no option for a conventional DIS.

Salient features of IDI

The design features of IDI and convectional deposit protection systems are more or less the same save for a few countries.
In some countries they have adopted a comprehensive IDI which ensures that it protects Islamic deposits with other operational aspects of the scheme being conformity with Sharia principles.

In Sudan, all deposits are Islamic and the IDI scheme is a fully fledged Islamic system, while in Turkey, Qatar, Kuwait, United Kingdom, Malaysia, Singapore, Indonesia and Bahrain authorities have implemented IDI alongside the conventional deposit insurance scheme, by virtue of the dual banking system. Of these nine, Malaysia is the only country that has established a separate system for its IDI, with a separate Islamic deposit insurance fund managed in accordance with Sharia principles.

Coverage

With respect to the coverage limit, all countries implementing dual deposit insurance set similar coverage limits for their Islamic and conventional insured deposits, so as to provide equal treatment and preserve the competitiveness of both Islamic and conventional deposit products. As regards the types of Islamic deposits, Sudan is the only country that sets a different coverage limit for its investment deposits (Islamic deposits accepted under a profit-sharing contract).

Membership

Membership is compulsory for commercial banks (including subsidiaries of foreign banks operating in these countries, finance companies and Islamic banks licensed under the Islamic Banking Act. In Jordan however membership is not compulsory, it is on a voluntary basis to Islamic banks licensed to operate in the country.

Powers

The IDI give powers to deposit insurers including power to reimburse depositors the insured limit in the event of a bank failure, power to liquidate insolvent institutions, regulatory and supervisory duties that include on-site examinations of contributory institutions. IDI gives insures powers for intervention and failure resolutions.

Fund Management

In Malaysia and Sudan the fund is managed according to Sharia principles while in some countries such as Turkey, UK and Indonesia they do not necessarily follow Shari'ah principles.

Insuring deposits

Where an IDIS is running parallel to a conventional DIS, Islamic and conventional deposits are separately insured up to the deposit insurance limit to avoid any competitive distortions between the two banking systems.
Premium contributions are based on contributory institution's total insured deposit base.
Depositors with deposits in more than one member institution are insured separately for their deposits in each institution.
Joint, trust, sole proprietorship and partnership deposits are also separately insured.

Funding

Funding consist of capital paid by the government and initial contributions made by each member bank. The deposit insurers levy an annual premium that is paid ex-ante based on total insurable deposits and in other countries its paid ex- post.

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