IOSR Journal of Business and Management (IOSR-JBM)
e-ISSN: 2278-487X, p-ISSN: 2319-7668. Volume 18, Issue 10. Ver. VI (October. 2016), PP 90-97
www.iosrjournals.org

Concept of Deposit Insurance: A Comparative Study between Conventional System and Shariah

Dr. Yusuf Sani Abubakar[1], Dr. Lukman Olorogun[2],
Dr. Ahamad Faosiy Ogunbado[3], Dr. Umar Ahmed[4]
[1,2,3,4]Senior Visiting Lecturer, Islamic Business School, College of Business, Universiti Utara Malaysia (UUM) Sintok Kedah, Malaysia.

Abstract: *Deposit insurance is a measure implemented in many countries to protect bank depositors, in full or in part, from losses caused by a bank's inability to pay debts when due. On the other hand, there have been a lot of discussions with regard to its permissibility from the Shariah point of view. This paper compares this concept between the conventional system and Shariah to see the similarities and differences between the two systems. The findings of the research show that many countries in the world implement deposit insurance system in their conventional system which is mostly associated with certain elements not permitted by Shariah. However, under the Islamic deposit insurance system, expenses acquired and any investments of the Islamic deposit insurance fund need to comply with Sharī`ah principles, whereby only permissible expenses are paid by the Islamic fund and the fund is invested in Islamic instruments. Moreover, under government regulation, the government effort to set up an Islamic deposit insurance system is considered being in line with the Islamic concept of SiyāsahShar`iyyah. Siyāsah Shar`iyyah refers to any action taken by the government in the interest of the public, or Maslahah.*
Keywords*: Deposit insurance, SiyasahShar'iyyah, bankrupt, Maslahah.*

I. Introduction

Deposit insurance is a measure implemented in many countries to protect bank depositors, in full or in part, from losses caused by a bank's inability to pay debts when due. Deposit insurance systems are component of financial system safety net that promotes financial stability. Deposit insurance is considered new in the Islamic finance. There have been a lot of discussions with regard to its permissibility from the Shariah point of view. This paper compares this concept between the conventional system and Shariah to see the similarities and differences between the two systems and to point out reasons –if any- why the concept in the conventional system is not Islamic. Section 1 of this research outlines the 'Concept of Deposit Insurance' and this will cover types of deposit insurance and the rationale for deposit insurance. Section 2 delineates Islamic deposit insurance which will elaborate on background of the Islamic deposit insurance; the need for an Islamic deposit insurance System; developing an Islamic deposit insurance System; and Malaysia's Islamic deposit insurance system. Finally the author will conclude by summarising the research findings.

1. Concept of Deposit Insurance

Deposit insurance serves as an element of financial safety net. Safety nets in banking are meant to provide assistance and encourage prudent risk taking (Kane, 2000) to depositors of bankrupt banks who have underrated the risks involved. Moreover, safety nets avoid disintermediation from the bank failures and banking system (Calomiris, 1999). Financial safety nets maintain confidence and soundness in the financial sector. Nevertheless, no consensus has been reached in the literature on a particular definition with regards to the key elements of the financial safety net (Sharifat et. al, 2012).

In line with the Financial Stability Forum (2001), financial safety nets comprise of three elements, namely: (a) a deposit insurance system; (b) lender of last resort; and (c) a prudential supervisory and regulatory framework. According to Walter and Weinberg (2002), federal safety nets are the explicit or implicit government guarantees to deposit taking institutions and the role plays by these governments in protecting depositors from losses incurred by bankrupt financial institutions. However, Schich (2008) provides a comprehensive definition of financial safety nets, where he added failure resolution as other element of the financial safety nets over the three elements suggested by the Financial Stability Forum (2001).

Mostly, financial safety nets comprises of the whole financial rules and institutions that are concerned with limiting and avoiding depositors' losses and safeguarding depositors' confidence in the occasion of a banking failure. According to this definition, safety nets consist of explicit and implicit deposit insurance structures, prudential regulation, a lender of last resort function and also failure resolution. Government in many countries provides insurance and other assistance to protect the financial systems. Generally, policy makers are advocates of deposit insurance as according to them it promotes financial stability in banking system and boosts depositors' confidence in the banking system since any interruption in a country's banks can possibly cause social costs outside the banking system. Therefore, it is important to protect banks, depositors and debtors from misfortune that may likely occur when depositors lose confidence in the banks (Sharifat et. al, 2012).

Despite the fact that deposit insurance was officially introduced in the US in the 1900s, its history began in the early 1800s. During that time, the insurance system was known as the New York's Safety Fund that covered only the New York State. The aim of that insurance system was the protection of deposits and circulates notes in case of a bank failure. But, the scheme did not succeed and was insolvent in 1842 as it was managed by a private-owned body which was not strong enough to fund the scheme like the one owned by the government. Afterwards, eight insurance schemes were established in the early 1920s but they failed as well as a result of limited funding and inadequate observing (Calomiris, 1990).Federal Deposit Insurance Corporation (FDIC) was the first federal government sponsored deposit insurance in the world, which was introduced in the United States of America in 1934. Contrary to the previous systems, the FDIC was sponsored through capital provided by the Treasury and the Federal Reserve Bank. This partial deposits guarantee provided under the FDIC structure remains until today with numerous reforms in the deposit insurance design features to return depositors' confidence and guarantee financial system stability (Sharifat et. al, 2012).

In Europe, Norway was among the first countries to implement deposit insurance for its savings institutions in 1921 and this was extended afterwards to commercial banks in 1938. For the meantime, in Western European countries, deposit insurance began between the late 1970s and the early 1980s. The failure of banks in Western Europe such as the BankhausHerstatt in Germany in 1974 caused the implementation of the deposit insurance system in some European countries like Belgium, Austria and France in 1974, 1979 and 1980 respectively. Additional, in 1994, most European countries had an explicit deposit insurance scheme ready to fulfill the European Union's Directive on Deposit Insurance. In the United Kingdom, official deposit insurance was first introduced in 1986 to safeguard depositors and members of the Building Societies Association. The introduction of the Financial Services Compensation Scheme in 2000 extended the deposit protection to all financial institutions as well as insurance companies. Away, in Canada, deposit insurance was introduced in 1967 and managed by the Canada Deposit Insurance Corporation. India was the first country in Asia to implement a deposit insurance system in 1961 followed by Philippine in 1963. Other countries in Asia such as Malaysia and Indonesia introduced a formal deposit insurance system in 2005 as a reaction to the Asian financial crisis in 1998/1999. In 1998, the deposit insurance system was accepted by the International Monetary Fund as 'best-international practice' (Sharifat et. al, 2012).

The financial crisis in 2007/2008 brought new attention to the idea and practice of deposit insurance by regulators around the world. Many countries that did not adopt or delayed in adopting a deposit insurance system have done so following the crisis. For example, Australia in response to the crisis was among the last countries to introduce the explicit deposit insurance system in October 2008.From only 12 countries, 2 introducing explicit deposit insurance in 1974 (Demirguc-Kunt&Sobaci, 2001), the numbers have gradually increased to 111 countries including Malaysia as at 31 March 2011. In another place, the 41 countries that have no official deposit insurance scheme are building or studying the application of an explicit deposit insurance system. For countries, that do not introduce an explicit deposit insurance scheme, there exists an implicit deposit insurance structure with an optional government guarantee or protection for the depositors (Sharifat et. al, 2012).

In order to share knowledge and expertise among the deposit insurers around the world, the International Association Deposit Insurance (IADI) was established on 6 May 2002. IADI was created in 2000 as a Working Group on Deposit Insurance instituted by the Financial Stability Forum (FSF). After that, on 8 June 2009, the *Core Principles for Effective Deposit Insurance System* was cooperatively issued by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers to promote a structure for active deposit insurance practices. The Essential Principles of the Effective Deposit Insurance System covered an extensive range of matters such as deposit insurance coverage, deposit insurer mandates and governance structures, membership and funding. These principles advocated as well swift reimbursement to depositors in a crisis to sustain stability. The principles likewise highlighted the significance of creating public responsiveness of deposit insurance and cooperation with other financial safety net players mostly governments through their Ministry of Finance and central banks. To sum up, the Core Principles for an effective deposit insurance system are an international set of plan features for effective deposit insurance system (Sharifat et. al, 2012).

1.1 Types of Deposit Insurance

Deposit insurance is normally in the form of either a full or limited guarantee to depositors that their deposits will be reimbursed by the deposit insurer to them in case the bank encounters failure. If the guarantee is explicitly clear in the legislation of a country, then this form of guarantee is identified as an explicit deposit insurance scheme. Or else, a form of implicit deposit insurance system is implied from the verbal promises and/or past actions of the governments.

i. Implicit Deposit Insurance

Implicit deposit insurance is a system of deposit insurance not clearly provided for by law or regulation. It is a system of a government guarantee to avoid complete failure to other banks when a bank experiences a bank failure as a result of insolvency or a bank run. Deposit insurance is implicit when its implementation builds public confidence to stop a bank run on banks that become economically insolvent. To repeat, for implicit deposit insurance, there is no formal communication by the government to the public or bankers on the deposit insurance coverage or the amount of its coverage (Demirguc-Kunt&Sobaci, 2001). Thus, the government is not legally bound to deliver deposit guarantee to depositors.

Even in an explicit deposit insurance system, there is a form of implicit deposit insurance system to evade the contagion effects of a distressed bank deafening the complete country's economy. The beginning of a banking crisis creates political incentives for any government including those with an explicit deposit insurance scheme to extend a guarantee coverage that surpass the limit of the explicit deposit insurance stated in the country's law and regulations. This is obvious in Malaysia where the government established a blanket guarantee known as the Government Deposit Guarantee in 1998 during the 1997/98 Asian financial crisis. Additional, the Government Deposit Guarantee was also introduced on 16 October 2008 and continued until 31 December 2010 in response to the 2007/2008 financial crisis. Furthermore, an implicit deposit insurance scheme is widespread in countries with one or more state-owned banks (Kane, 2000). Despite being unfunded, an implicit deposit insurance scheme is important and exists everywhere in the world.

ii. Explicit Deposit Insurance

The previous section focused on the distinct features of an implicit deposit insurance scheme as a system that is neither publicly communicated by the government nor by deposit insurance coverage. But, an explicit deposit insurance scheme is well-defined by the government in laws and other regulations which specify the existence of a deposit insurance scheme and the amount covered. Under this scheme, the government openly outlined its assurance through regulation a detailed amount of guaranteed protection on deposits. Both implicit and explicit deposit insurance schemes can co-exist mainly in a serious financial crisis to reduce the social costs involved (McCoy,2007).

Contrasting the implicit deposit insurance scheme, the explicit deposit insurance system has four different design features; (i) the funding type, (ii) sources of funds, (iii) insurance premiums systems and (iv) the coverage limits and coinsurance (see for example Schooner & Taylor, 2010; Demirguc-Kunt, Kane, &Laeven, 2008; LaBrosse& Mayes, 2007; Demirguc-Kunt&Detragiache, 2002; Demirguc-Kunt&Sobaci, 2001). Moreover, explicit deposit insurance funding consists of three components, i.e., ex-ante funding, ex-post funding and hybrid funding. In ex-post funding, there are no advance contributions and members simply contribute to the fund after a bank failure. In ex-ante funding, members contribute to a well-known permanent fund occasionally while hybrid funding is a mutual ex-ante and ex-post funding mechanism (Sharifat et. al, 2012).

For the sources of funds, there exist government sources for example in the form of grants, private sources from members' premium contribution and also a mixture of both government and private sources. For private sources of funding, the amount each bank has to pay can be either a fixed rate (uniform) insurance premium or a differential (risk-based/adjusted) insurance premium. The difference between the two is the premiums calculation method. With the fixed rate insurance premium, all member banks pay comparable insurance premium amounts regardless of their risk portfolios. Differential insurance premiums conversely incorporate the risk of each bank's assets into the premium structure (Sharifat et. al, 2012).

Apart from the aforementioned three design features of deposit insurance (funding type, sources of fund and insurance premiums systems), the final design features for explicit deposit insurance scheme are the limit of coverage and coinsurance. Limited coverage of deposit insurance will still instill market discipline among the cultured depositors like corporate depositors whose value of deposits with the banks will never be entirely insured under the deposit insurance because they make up a considerable amount of banks' deposits. Coinsurance (contrasted with reimbursing the whole insured amount) necessitates the depositor to cover some of the losses of a bank failure. For instance, say a deposit is covered up to the maximum of $20,000. In the occasion of a bank failure, depositors will not be compensated the maximum protection limit of $20,000. The deficit is the coinsurance amount or the loss borne by the depositors (Sharifat et. al, 2012).

1.2 The Rationale for Deposit Insurance

If deposit insurance is the reason for moral hazards (i.e. increases in bank risk taking) as discussed in the previous paragraph then why does it continue to exist? The seminal work by Diamond and Dybvig (1983) shows that even healthy banks can default because of a bank run. As the banking landscape is changing quickly followingliberalisation; banks depend onmarketforces and therefore become more exposed and submit themselves to greater volatility (Caprio&Honohan, 1999). In response to the 1997/98Asian financial crisis, the Financial Stability Forum was introduced by the G7 Finance Ministers and Central Bank Governors to promote global financial stability. In April 2008, this forum recommended that deposit insurance be incorporated as part of the vigorous mechanism that deals with financial institutions in grief. The systemic risk that financial institutions may misrepresent towards the financial system is a vital argument to regulate financial institutions beyond their institutional risk (Nijskens& Wagner, 2011).

II. Islamic Deposit Insurance

2.1 Background of the Islamic Deposit Insurance

The Islamic deposit insurance system is a plan to protect insured depositors against the loss of their insured Islamic deposits kept with the Islamic banking institutions (IBIs) in the event of the failure of an IBI.The concept of deposit insurance in the Islamic financial industry is comparatively new. Few countries have applied deposit insurance, and little has been written about its development and implementation (Khairuddin, 2011).

In the current landscape of the Islamic financial industry, only Sudan and Malaysia have applied an ex-ante Islamic deposit insurance system, while conventional deposit insurance systems have been applied in over 100 countries. In an ex-ante deposit insurance system, premiums are collected from member banks before a failure occurs. Sudan established 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 like Turkey, Indonesia and a few others, Islamic deposits in Islamic financial institutions are protected under the countries' separate conventional deposit insurance systems. Other countries around the globe that offer Islamic deposit products, conversely, 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 applied in other countries caused by, among other reasons, the small size of Islamic deposits compared to total deposits in the overall financial system. Lack of clearness on the insurability of profit-sharing investment accounts (or PSIA), which form the bulk of total Islamic funds, also impedes the development of the Islamic deposit insurance system (Khairuddin, 2011).

2.2 The need for an Islamic Deposit Insurance System

Notwithstanding the current low presence of a *Shari'ah*-compliant deposit insurance system internationally, it has attracted significant attention and rising interest in how to apply such a system so that it supplements the existing financial safety nets within the Islamic financial industry. This growing awareness is by reason of 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 appeared as an exciting, 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 expected to grow more to provide the needs of the growing Muslim population that has almost reached one-fourth of the world's population. All-inclusive 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 latest global financial crisis that affected conventional financial institutions caused 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 harshness and rate of financial crises (Khairuddin, 2011).

A *Sharī`ah*-compliant deposit insurance scheme may be required 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 thus produce a level playing field between the Islamic and conventional banking products, and this can further boost the growth of the Islamic financial industry by reducing the potential loss of Islamic deposits from IBIs to conventional banks. Second, the Muslim community aims to have a deposit insurance scheme that is consistent with *Sharī`ah* requirements and appropriates with their way of life. By the way, the system must not have elements that are strictly forbidden, 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. And finally, establishing an Islamic deposit insurance system could be helpful to a country that practices Islamic finance. A complete safety net within the Islamic financial industry would contribute to the strength of the system (Khairuddin, 2011).

2.3 Developing an Islamic Deposit Insurance System

Generally, the role of Islamic and conventional deposit insurance systems is similar, whereby the deposit insurer collects premiums from banks and protects the insured depositors of an insolvent bank. In developing *Sharī`ah*-compliant deposit insurance, the assumption of some general features of conventional deposit insurance, such as operating the system under an exanteor ex-post model, as a pay box or risk minimiser model, and so on, shall be taken into consideration first. Any features that do not conform to the *Sharī`ah* principles shall then be distant. Under the Islamic deposit insurance system, expenses acquired and any investments of the Islamic deposit insurance fund need to 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.
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.
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 *paripassu*, 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 practice 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 (Khairuddin, 2011).

The implementation of an Islamic deposit insurance system will rely on how the government in the respective country views the permissibility of the system from the *Sharī`ah* perspective. There are generally numerous approaches that a government could take in implementing a *Sharī`ah*-compliant deposit insurance system – that is, government regulation, *Sharī`ah* contract, or a combination of both. Still, 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 must ensure it is in line with the Islamic concept of *SiyāsahShar`iyyah*. *Siyāsah Shar`iyyah* 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 supported 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. Provided that the deposit insurance system does not contradict any substantive principle of *Sharī`ah*, there is no harm in introducing, implementing, executing or enforcing it (Khairuddin, 2011).

Why are other approaches needed if the government can enforce its regulation in implementing deposit insurance? Other approaches are used where the government, in consultation with *Sharī`ah* scholars, have confidence that the public interest argument alone is inadequate to justify a *Shari'ah*-compliant deposit insurance system. Implementation of a *Shari'ah*contract is the best available means to reflect the intention and consent of contracting parties. In the *Qur'an*, there are a number of 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 *Kafālahbil `Ujr*(guarantee with fee) and *Takāful*(mutual guarantee) contracts (Khairuddin, 2011).

It is essential to note that different contracts come with different conditions or requirements, and therefore it is possible to create deposit insurance systems with different designs or features. The main test 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 expected that challenges may arise when adopting the *Sharī`ah* contract approach alone. Hence, the best solution for dealing with 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 harmonized with the conditions will be addressed by government regulation, which is made permissible by *Siyāsah Shar`iyyah*. For example, 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 (Khairuddin, 2011).

2.4 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 September2005 pursuant to the enactment of the Malaysia Deposit Insurance Corporation Act(MDIC Act). Malaysia's Islamic deposit insurance system operates independently from the conventional system, but both systems are administered solely by the Malaysia Deposit Insurance Corporation (MDIC).MDIC adopts a contract-based approach – *Kafālahbil `Ujr*– in the implementation of an Islamic deposit insurance system. The contract has been certified 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 *Kafālahbil `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 (Khairuddin, 2011).

There has been current debate about the adoption of the *Kafālahbil `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 *Kafālahbil `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 (Khairuddin, 2011).

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 *Sharī̃ah* 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-*Mudārabah*deposits are given priority over *Muḍārabah*deposits (Khairuddin, 2011).

It is admitted 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 (Khairuddin, 2011).

III. Conclusion

The research reveals that deposit insurance is a measure implemented in many countries. It serves as an element of financial safety net. Safety nets in banking are meant to provide assistance and encourage prudent risk taking to depositors of bankrupt banks who have underrated the risks involved. There are two types of deposit insurance, namely, explicit and implicit. If the guarantee is explicitly clear in the legislation of a country, then this form of guarantee is identified as an explicit deposit insurance scheme. Or else, a form of implicit deposit insurance system is implied from the verbal promises and/or past actions of the governments.

On the other hand, it has been suggested that in developing *Shari'ah*-compliant deposit insurance, the assumption of some general features of conventional deposit insurance, such as operating the system under an exanteor ex-post model, as a pay box or risk minimiser model, and so on, shall be taken into consideration. Any features that do not conform to the *Shari'ah*principles shall thenbe distant. Under the Islamic deposit insurance system, expenses acquired and any investments of the Islamic deposit insurance fund need to comply with *Sharī`ah* principles, whereby only permissible expenses are paid by the Islamic fund and the fund is invested in Islamic instruments. Under government regulation, the government effort to set up an Islamic deposit insurance system must ensure it is in line with the Islamic concept of *SiyāsahShar`iyyah*. *Siyāsah Shar`iyyah* 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.

In Malaysia Islamic deposit insurance system operates independently from theconventional system, but both systems are administered solely by the Malaysia Deposit Insurance Corporation (MDIC). MDIC adopts a contract-based approach – *Kafālahbil `Ujr*– in the implementation of an Islamic deposit insurance system. The contract has been certified 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 *Kafālahbil `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.

References

[1]. Bank Negara Malaysia (2009).80 meeting of the Shariah Advisory Council. Retrieved from http://www.bnm.gov.my/microsites/financial/pdf/resolutions/10_part04.pdf .

[2]. Calomiris, C. W. (1990). Is deposit insurance necessary? A historical perspective. *Journalof Economic History, 50 (2),* 283-295.

[3]. Calomiris, C. W. (1999). Building an incentive-compatible safety net. *Journalof Banking& Finance, 23,* 1499-1519.

[4]. Caprio, G., &Honohan, P. (1999). Restoring banking stability: Beyond supervised capital requirements. *Journal of Economic Perspectives, 13,* 43-64.

[5]. Demirguc-Kunt, A., &Detragiache, E. (2002). Does deposit insurance increase banking system stability? An empirical investigation.*Journal of Monetary Economics, 49,* 1272-1406.

[6]. Demirguc-Kunt, A., &Sobaci, T. (2001). A new development database: Deposit insurance around the world. *The World Bank Economic Review, 15,* 481-490.

[7]. Demirguc-Kunt, A., Kane, E. J., &Laeven, L. (2008).Determinants of deposit-insurance adoption and design. *Journal of Financial Intermediation, 17,* 407-438.

[8]. Diamond, D. W., &Dybvig, P. H. (1983). Bank runs, deposit insurance and liquidity. *Journal of Political Economy,* 401-419.

[9]. Financial Stability Forum.(2001). *Guidance for developing effective deposit insurance system.*

[10]. Kane, E. J. (2000). Designing financial safety nets to fit country circumstances. *WorldBank Policy Research Working Paper No. 2453.*

[11]. LaBrosse, J. R., & Mayes, D. G. (2007).Promoting financial stability through effective depositor protection: The case for explicit limited deposit insurance. In A. Campbell, J. R. LaBrosse, D. G. Mayes, & D. Singh (Eds.), *Deposit Insurance* (pp. 1-39). New York: Palgrave Macmillan.

[12]. Malaysia Deposit Insurance Corporation Act 2005

[13]. McCoy, P. A. (2007). The moral hazards implications of deposit insurance: Theory and evidence. *International Monetary Fund Seminar on Current Developments in Monetary and Financial Law.*

[14]. MdKhairuddin, H. A. (2011).Implementation of an Islamic Deposit Insurance System for the Islamic Financial Services Industry. Fourth Islamic Financial Stability Forum *Kuala Lumpur, Malaysia.*
[15]. Nijskens, R., & Wagner, W. (2011). Credit risk transfer activities and systemic risk: How banks became less risky individually but posed greater risks to the financial system at the same time. *Journal of Banking and Finance, 35,* 1391-1398.
[16]. Schich, S. (2008). Financial crisis: Deposit insurance and related financial safety net aspects. *Financial Market Trends 2,* 76-121.
[17]. Schooner, H. M., & Taylor, M. W. (2010).*Global Bank Regulation: Principles and Policies.* United States of America: Elsevier.
[18]. Sharifah, A. S. A. &Rubi A. (2012). Deposit Insurance: Concept and Theory. *Banker's Journal Malaysia,* No. 138-2012, 3-9.
[19]. Walter, J. R., & Weinberg, J. A. (2002). How large is the federal financial safety nets? *Cato Journal, 21,* 369-393.