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Shari'ah Approaches for the Implementation of Islamic Deposit Insurance Systems

Discussion Paper

**Prepared by the Islamic Deposit Insurance Group of the
International Association of Deposit Insurers**

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About the Islamic Deposit Insurance Group

The Islamic Deposit Insurance Group (IDIG) was established in 2007 under the aegis of the Research and Guidance Committee of the International Association of Deposit Insurers (IADI). The Group is responsible for conducting research as well as developing and promoting guidance and core principles to enhance the effectiveness of Islamic deposit insurance systems, for the benefit of countries seeking to establish or improve their Islamic deposit insurance system.

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Definition of key terms

Gharar is the state of uncertainty that exists when the process of concluding a transaction involves an unknown aspect. In other words, gharar refers to results that may or may not materialize.

Investment accounts are non-principal guaranteed products accepted by institutions offering Islamic financial services based on Shari'ah contracts such as profit-sharing (mudarabah) and agency (wakalah).

Islamic deposits are principal guaranteed products accepted by institutions offering Islamic financial services based on Shari'ah contracts such as safe custody (wadi'ah), interest-free loan (qard), cost-plus (murabahah) and other debt-based contracts.

Kafalah means the conjoining of the guarantor's liabilities to those of the guaranteed, such that the debt or other responsibility of the original bearer is established as a joint liability of both parties.

Mudarabah investment account is a product in which the investor (account holder) contributes capital to an enterprise or activity that is to be managed by the entrepreneur (institution offering Islamic financial services). Profits generated by the enterprise or activity are shared in accordance with the terms of the mudarabah agreement, while losses are borne solely by the investor unless they are due to the entrepreneur's misconduct, negligence or breach of contract.

Murabahah deposit is a product in which the seller (depositor) sells to an institution offering Islamic financial services a specified kind of asset that is already in the seller's possession at cost plus an agreed profit margin (selling price), to be paid at a future date.

Qard deposit is a product in which the lender (depositor) lends funds to the borrower (institution offering Islamic financial services) for a specified period, with the understanding that the same amount as the loaned funds will be repaid to the lender at the end of the period.

Restricted investment account refers to funds accepted by institutions offering Islamic financial services, with certain restrictions as to where, how and for what purpose these funds are to be invested.

Ta'awun is the concept whereby the participants' initial objective is to assist each other mutually for the losses arising from specified risks.

Tabarru' is the amount of contribution to be rendered by a takaful participant as a donation for fulfilling the obligation of mutual help, and to be used to pay claims submitted by eligible claimants.

Takaful is derived from an Arabic word meaning 'solidarity', and is the concept whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.

Ujr means commissions or fees charged for services provided.

Unrestricted investment account refers to funds accepted by institutions offering Islamic financial services, without restrictions as to where, how and for what purpose these funds are to be invested in a pooled portfolio.

Wadi'ah deposit is a product in which the safekeeper (institution offering Islamic financial services) guarantees the safety of the deposit entrusted by the principal (depositor). The safekeeper may charge a fee for looking after the deposit and may pay hibah (gift) to the principal.

Wakalah investment account is a product in which the principal (account holder) appoints an agent (institution offering Islamic financial services) to carry out an investment on the principal's behalf.

Executive summary

Islamic deposit insurance is a scheme or system that, in the event of failure of an institution offering Islamic financial services (IIFS),¹ provides a guarantee to insured Islamic deposits and investment accounts held by such institutions. The system differs from the conventional deposit insurance system as the former is required to adhere to Islamic law (Shari'ah).

The conventional deposit insurance model is arguably non-permissible from the Shari'ah perspective. This is because of the presence of excessive gharar, or uncertainty, in the conventional model, which is prohibited in Islam. Therefore, to facilitate the implementation of an Islamic deposit insurance system (IDIS), there is a need to devise permissible or more acceptable approaches based on Shari'ah rules and principles, with the consultation of Shari'ah scholars.

This paper presents an overview of the currently adopted Shari'ah approaches for the implementation of IDIS. The focus is on the approaches of Sudan and Malaysia, as well as the model being developed in Jordan.

Sudan and Jordan have adopted the takaful (joint guarantee) model for their IDIS. The model involves cooperation between the IIFS and the investment account holders. These parties are the system participants, and agree to contribute funds to the system to mutually guarantee the deposits and investment accounts held by the IIFS, in the event that an IIFS fails or is insolvent. In Sudan, the cooperation extends to the Ministry of Finance and the Central Bank of Sudan as they also contribute funds to the system. In Jordan, the Government also takes part in the cooperation through the Ministry of Finance.

In Malaysia, the IDIS is based on the Shari'ah concept of kafalah bi al ujr (guarantee with fee). Under the system, the deposit insurer agrees to guarantee insured deposits and investment accounts held by an IIFS in the event of the IIFS becoming insolvent. For such a commitment, the IIFS pays a fee to the deposit insurer.

This paper suggests some of the IDIS design features that policymakers need to consider when adopting a particular model, as follows:

- (a) The role of the deposit insurer under the system, e.g. manager of deposit insurance fund, or owner of deposit insurance fund;

¹ 'Institutions offering Islamic financial services' refers to financial institutions that manage funds such as deposits and investment accounts in accordance with Shari'ah rules and principles, and invest them in Shari'ah compliant investment and financing instruments.

- (b) Funding for the system, especially for the guarantee of investment accounts, i.e. whether such guarantee should be funded by investment account holders or IIFS; and
- (c) Addressing a deficiency in the deposit insurance fund.

Different Shari'ah approaches give rise to differences in deposit insurance design features. Regardless of the different design features, policymakers should ensure that the IDIS is effective for the protection of Islamic deposits and investment accounts, as well as promote the stability of their Islamic banking systems.

Introduction

Islamic deposit insurance is a scheme or system that provides a guarantee to insured customer funds (in the form of Islamic deposits and investment accounts²) held by IIFS in the event of an IIFS failure. The system differs fundamentally from its conventional counterpart as the former is required to adhere to Islamic law (Shari'ah), whose rules and principles are drawn from the main sources the Quran and the Sunnah (the tradition of the Prophet Muhammad pbuh).

IDISs are relatively new – the first explicit system was introduced in Bahrain only in 1992. As such, there are few, if any, rules and principles about the systems that can be drawn from Shari'ah sources. Nonetheless, in view of the need to develop and implement IDISs for the benefit of their financial consumers and the stability of their Islamic banking systems, a few jurisdictions have had recourse to Shari'ah scholars to seek Islamic viewpoints as to the basis for the permissibility of the system.

As far as the deposit insurance model is concerned, some Shari'ah scholars invalidate the model, citing the existence of excessive gharar,³ or uncertainty, as the underlying reason. They take the view that conventional deposit insurance is a form of sale contract and the uncertainty element arises where banks pay a purchase price (in the form of deposit insurance premiums) for a guarantee from deposit insurers which may or may not materialize.⁴ Gharar in a sale contract is strictly prohibited in Islam. Hence, permissible or more acceptable approaches need to be devised so as to facilitate the implementation of IDISs by governments or deposit insurers.

In principle, most Shari'ah scholars have no objection to the implementation of an IDIS, owing to the aforesaid benefits of the system. The system not only has a solid rationale, it is in fact consistent with the teachings of Islam, in which any conduct or practice that aims to safeguard the interest of the general public achieves the objective of Shari'ah, and is thus permissible.

² Islamic deposits and investment accounts are customer funds that normally form the bulk of an IIFS's total funds. Islamic deposits are principal guaranteed products accepted under various Shari'ah contracts, such as wadi'ah (safe custody), qard (interest-free loan), and murabahah (cost-plus). Investment accounts are non-principal guaranteed products accepted under the Shari'ah contracts of mudarabah (profit-sharing), musharakah (profit- and loss-sharing), and wakalah (agency). The insurability of these products under deposit insurance is discussed in the paper "Insurability of Islamic Deposits and Investment Accounts" prepared by the Islamic Deposit Insurance Group of the International Association of Deposit Insurers.

³ Gharar (uncertainty) is one of the elements prohibited by Islam in Islamic financial transactions or conduct. Other prohibited elements include riba (interest) and maysir (gambling).

⁴ The same argument was used as a basis for the invalidity of commercial insurance contracts.

Nonetheless, Shari'ah scholars are of the view that the system must be developed and implemented using approaches based on Shari'ah rules and principles (hereinafter referred to as 'Shari'ah approaches'). Shari'ah approaches will facilitate deposit insurers in adopting permissible deposit insurance models and ensuring that the design features are Shari'ah-compliant.

In developing an IDIS, Shari'ah scholars should be consulted on the approaches underlying the system. The system's design features need to be clearly presented to them, so as to allow a sound understanding of the system and facilitate informed decision-making by the scholars.

To this end, policymakers may develop approaches for IDISs by applying relevant Shari'ah concepts. The concepts are translated into contracts or any forms of arrangement that, *inter alia*, set out the legal basis for implementation of the system as well as clarify the relationship between, and the responsibilities of, the parties involved in the system.

The Islamic Deposit Insurance Group (IDIG) of the International Association of Deposit Insurers (IADI) is of the view that the application of Shari'ah approaches is critical for the development and implementation of IDISs so as to, among other things: ensure that the system is compliant with Shari'ah rules and principles; build confidence, among Muslim stakeholders especially, as to the permissibility of the systems; preserve the reputations of governments or deposit insurers; and promote the effectiveness of the system. Against this backdrop, the IDIG aims to present in this paper an overview of Shari'ah approaches for the implementation of an IDIS, to serve as a guide for policymakers.

The scope of this paper is to highlight the approaches resolved by the Shari'ah scholars from the jurisdictions that have implemented the system, and from a jurisdiction that has sought Shari'ah views for future introduction of a system. The paper also describes the implications of the approaches to the design features of the system.

To date, only a few countries have implemented an IDIS, although a number of jurisdictions provide Islamic banking services. Malaysia and Sudan are the only jurisdictions that provide a guarantee for Islamic deposits and investment accounts under an IDIS. Some other countries, such as Indonesia and Turkey, provide such a guarantee under the conventional system. Jordan is currently in the process of amending its law to adopt an IDIS alongside its conventional deposit insurance system.

In this regard, the paper will focus on the Shari'ah approaches adopted by Sudan and Malaysia in implementing their respective systems. The IDIS in

Jordan is, in principle, based on an approach similar to Sudan's system. Hence, the views of Jordan's Shari'ah scholars are also covered in the paper.

Sudan's approach: takaful model

Sudan introduced its IDIS in 1996, following the enactment of the Bank Deposit Security Fund Act 1996. The system is administered by the Bank Deposit Security Fund (BDSF); the aim is to contribute to the stability of the financial system as well as protect depositors and investment account holders.

Sudan was the first country to implement a fully fledged Islamic banking system, and accordingly an explicit fully fledged IDIS. Membership of the IDIS is compulsory for all IIFS and foreign bank branches in the country. The implementation of the IDIS in Sudan was endorsed by the Shari'ah High Advisory Board (SHAB) of the Central Bank of Sudan, which ruled that the system be implemented based on the takaful (joint guarantee or solidarity) concept.

Takaful is an arrangement in which a group of participants mutually agree to help a participant in the scheme who suffers loss or damage arising from specified risks. In such arrangements, the participants agree to make contributions (tabarru') into a fund.

The concept of takaful is derived from the following Shari'ah principles:

- (a) Tabarru' (commitment to contribute)

The tabarru' commitment is the contribution made by each takaful participant to fulfill the obligations of mutual assistance and to pay claims submitted by eligible claimants.

- (b) Ta'awun (mutual assistance)

This is the concept under which participants agree to assist each other mutually for the losses arising from specified risks. It supports a takaful arrangement as a form of cooperative or mutual insurance rather than a profit-making arrangement.

The application of the takaful concept for Sudan's IDIS involves the cooperation among IIFS, investment account holders, the Ministry of Finance and the Central Bank of Sudan. These are the system participants, and they agree to mutually guarantee the deposits and investment accounts held by IIFS in the event that an IIFS fails or is wound up. So as to provide the financial guarantee, they

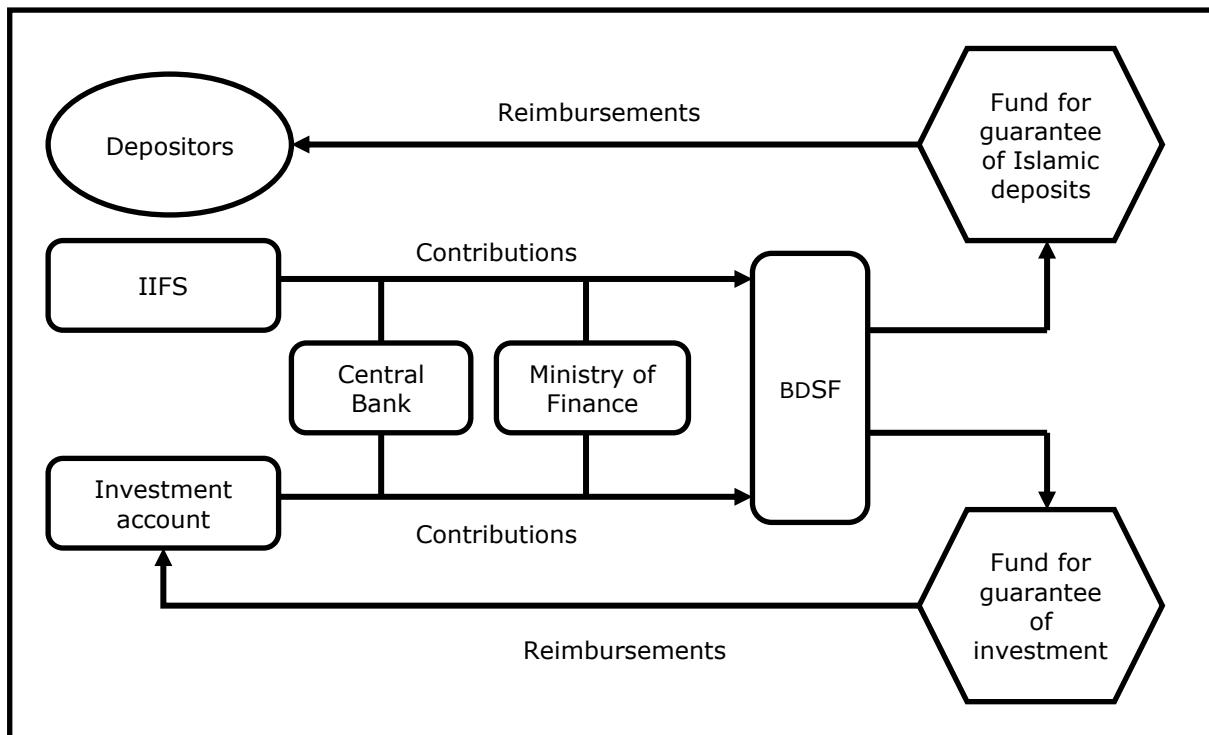
commit to make contributions on a voluntary basis.⁵ Under Shari'ah, the voluntary nature of the tabarru' commitment mitigates the element of uncertainty in deposit insurance as participants do not expect any financial compensation.

Under Sudan's IDIS, participants' contributions are maintained in two takaful funds – one for the guarantee of deposits and another for the guarantee of investment accounts. This separation of funds is attributed to the SHAB's resolution that IIFS shall not participate in guaranteeing the capital of investment account holders.

For the establishment of the takaful funds, initial capital was contributed by the IIFS, the Ministry of Finance and the Central Bank of Sudan. Subsequent contributions to the funds in the form of annual deposit insurance premiums are made by the respective participants in the funds.

The subsequent contributions to the takaful fund for the guarantee of deposits, i.e. current account and savings deposits, are made by the IIFS, the Ministry of Finance and the Central Bank of Sudan. For the guarantee of investment accounts, the subsequent contributions to the fund are made by the investment account holders, the Ministry of Finance and the Central Bank of Sudan. The following diagram illustrates Sudan's IDIS.

Diagram 1: Sudan's IDIS based on the takaful model



⁵ While in principle the contribution is voluntary, it can be binding due to the fact that the participants agree to participate in the system.

The annual premiums are calculated as a flat rate based on the average total insured Islamic deposits and investment accounts held as at 31 December of the preceding year. The Ministry of Finance and the Central Bank of Sudan each pay 10% of the total amount of the annual IIFS premiums.

The takaful funds are owned by the respective participants, and both funds have a separate legal and financial status. They are only managed by the BDSF, which is mandated to utilize the takaful funds to reimburse insured deposits and investment accounts in the event of an IIFS failure.

For the reimbursement in the event of the winding-up of an IIFS, the BDSF is allowed by the SHAB to prescribe the coverage limit. It is also allowed to determine the amount payable to depositors and investment account holders. Such amount is the outstanding amount at the point of winding up, consisting of principal amount plus profit which has been credited to the account, including profit declared but not yet credited up to the date of winding up. For investment accounts, investment losses are deducted when calculating the amount payable.

The BDSF is also allowed to utilize the takaful funds for other purposes, as per the terms and conditions of the takaful arrangement. However, it is required to ensure that expenses are incurred for permissible activities only. The surpluses after deducting expenses are invested solely in Shari'ah-compliant instruments. For managing the funds, the SHAB resolved that the BDSF is entitled to a fee based on the Shari'ah concept of wakalah bi al ujr (agency with fee).

To maintain confidence in the financial system, the BDSF is required to reimburse the insured depositors and investment account holders of a failed IIFS quickly, and by law no longer than three months from the date of a winding-up order. The priority of payments set out in the Banking Business (Organization) Act 1991 provides a basis for the reimbursement of depositors.

All losses incurred by the BDSF in reimbursing insured deposits and investment accounts are to be charged appropriately to the respective takaful funds. In cases where a takaful fund is in deficit, the SHAB has ruled that the BDSF is allowed to withdraw funds from the other takaful fund in the form of an Islamic loan. It is also allowed to source additional funds from the Government or market based on Shari'ah principles.

Once the BDSF has reimbursed insured deposits and investment accounts, the takaful funds are subrogated to the extent of the amount of the payment made, to all the rights and interests of the depositors and investment account holders. This allows the BDSF to recover the losses incurred and restore the depleted takaful funds for future reimbursements.

Jordan's approach: takaful model⁶

The Jordan Deposit Insurance Corporation (JODIC) was established in 2000 by Law no. 33 of the same year, with the aim of protecting depositors by insuring their deposits with banks in order to encourage savings, enhance confidence in the banking system, and thus achieve financial stability in the Hashemite Kingdom of Jordan.

Currently, membership of Jordan's deposit insurance system is compulsory for commercial banks; membership for IIFS is voluntary, and none of them has become a member of the system.⁷

In the 13 years since JODIC's establishment, the size of Islamic deposits and investment accounts has expanded to 19% of total deposits in the banking system. In view of the growing significance of the Islamic banking industry in Jordan, efforts are currently underway to introduce an Islamic deposit insurance scheme in tandem with the conventional deposit insurance system.

The essential step is to issue the Fatwa, or legal interpretation that views the permissibility of deposit insurance from a Shari'ah perspective. The Fatwa Council of Islamic Studies and Research has issued the requisite Fatwa⁸ for establishing an Islamic deposit insurance fund. The fund's structure is compliant with the Shari'ah principles of takaful and ta'awun. Its financial resources will be considered as a donation (tabarru'). IIFS and investment account holders contribute to the fund, whereas the Ministry of Finance contributes to the capital on a pro rata basis, by analogy with the conventional system.

The fund will enjoy the status of a legal entity. Therefore, JODIC will segregate the Islamic deposit insurance fund and administer it separately and independently from the conventional deposit insurance fund. No commingling or cross-subsidization will occur between the two funds. The fund will be managed by JODIC under the wakalah bi al ujr (agency with fee) arrangement.

The fund insures Islamic deposits and investment accounts – specifically, unrestricted accounts, which comprise two portions: an invested portion and an uninvested portion, whereby the percentage of each portion is designated in a separate contract with the capital provider. However, restricted investment accounts for which an IIFS acts as agent are not insured, as the investors are more sophisticated and are assumed to evaluate the risks of the projects in which they choose to invest.

⁶ To date, Jordan's IDIS has yet to be operationalized. The country has made good progress in introducing the IDIS, as the Cabinet approved the proposed amended version of the JODIC Law in June 2013.

⁷ The proposed amended version of the JODIC Law stipulates compulsory membership for IIFS.

⁸ The General Ifta' Department issued its Fatwa no. (13/2012) dated 20 September 2012 regarding the permissibility of insuring deposits held with an IIFS (Appendix 2).

On the basis of the above-mentioned guaranteed accounts, the fund has been divided into two portfolios: a takaful portfolio for credit accounts (includes Islamic deposits and the uninvested portion of investment accounts), and a takaful portfolio for the invested portion of unrestricted investment accounts. The premium fees paid to the Corporation against insuring credit accounts are to be borne by the IIFS, whereas the annual premium fees for the invested portion of investment accounts are to be borne by the investors themselves and paid by the IIFS on their behalf.

However, in the event of an IIFS failure the above-mentioned insured deposits and accounts will be covered to the maximum coverage limit of JOD 50,000, which is equivalent to USD 71,430 of deposits for each depositor at each IIFS. Amounts reimbursed in case of liquidation comprise a principal amount plus profit which has been credited to the account, including profit declared but not yet credited up to the date of winding up.

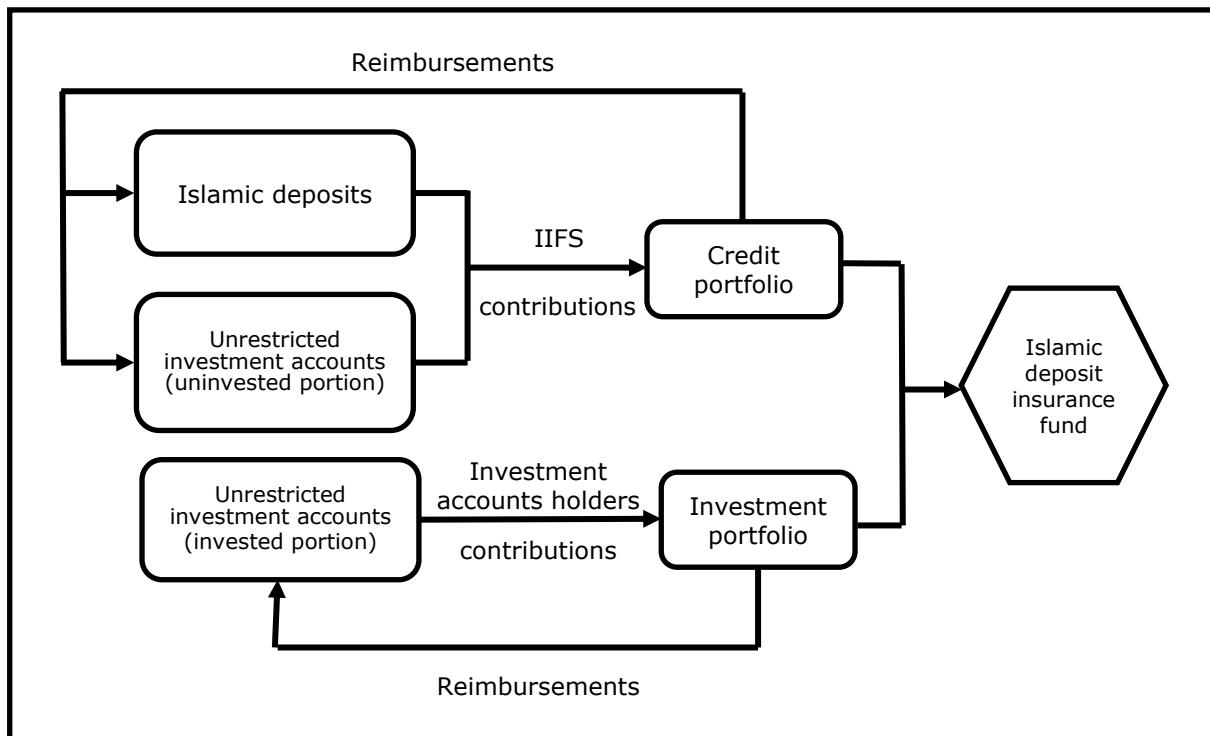
The fund's reserves must be invested in Shari'ah-compliant and risk-free instruments, such as sukuk issued by the Government. Reimbursement for Islamic deposits and investment accounts is made from the relevant takaful portfolio. The fund may borrow in the form of a benevolent loan (qard hasan) from JODIC's conventional fund or from any third party in case of the fund's deficiency.

With regard to the priority of reimbursement payments, all Islamic deposits and investment accounts are ranked pari passu.

In the event of the fund's liquidation, the remaining balance will be transferred to the Zakat⁹ Fund, after covering all losses and expenses incurred by the Islamic fund.

⁹ Zakat means the amount payable by a Muslim on his net worth as part of his religious obligations, mainly for the benefit of the poor and the needy. Paying Zakat is an obligatory duty for every adult Muslim whose wealth exceeds a certain threshold.

Diagram 2: Jordan's IDIS based on the takaful model



The Islamic fund in Jordan features a unique mechanism that differs from Sudan's and Malaysia's models in several approaches:

- (a) Unlike Sudan's and Malaysia's models, where the fund is owned either by the participants or by the corporation itself, Jordan's fund ownership involves IIFS and investment account holders. Nevertheless, in the event of the fund's liquidation, the remaining balance will be transferred to the Zakat Fund, after covering all losses and expenses incurred by the Islamic fund;
- (b) The premium fees paid to the Corporation against insuring credit accounts (includes Islamic deposits and the uninvested portion of investment accounts) are to be borne by the IIFS, whereas the annual premium fees for the invested portion of investment accounts are to be borne by the investors themselves and paid by the IIFS on their behalf;
- (c) Restricted investment accounts are not protected by JODIC since most holders of such accounts are sophisticated depositors and the IIFS acts as agent, unlike the MDIC, where both restricted and unrestricted investment accounts are protected.

Malaysia's approach: kafalah bi al ujr model

Malaysia introduced its IDIS on 1 September 2005 following the enactment of the Malaysia Deposit Insurance Corporation Act 2005. The system is administered by the Malaysia Deposit Insurance Corporation (MDIC) to provide protection for Islamic deposits and investment accounts, provide incentives for sound risk management among IIFS, and promote or contribute to the stability of Malaysia's Islamic financial system.

Given its dual banking system, Malaysia implements a dual deposit insurance system, in that the IDIS is implemented separately but in parallel with the country's conventional deposit insurance system. Membership of the IDIS is compulsory for all IIFS licensed under the Islamic Financial Services Act 2013.

The implementation of an IDIS in Malaysia was endorsed by the Shari'ah Advisory Council (SAC) of Bank Negara Malaysia – the highest Shari'ah authority, which provides resolutions on Islamic finance matters in Malaysia. In view of the importance of an IDIS in building public confidence and promoting the country's financial system stability, the SAC took the view that the implementation of the system does not contradict Shari'ah. Having understood the design features of the system, the SAC resolved that the system could be implemented based on the concept of guarantee with fee (kafalah bi al ujr).

Kafalah means 'conjoining of the guarantor's liability to the liability of the guaranteed'. Thus, the debt would be established as a joint liability on both parties. Ujr means 'a fee paid for the provision of a service'. Under kafalah bi al ujr, the fee is paid for the commitment to guarantee.

Under Malaysia's IDIS, the MDIC agrees to provide a guarantee commitment to an IIFS that, in the event of the latter's failure, all its insured deposits and investment accounts will be reimbursed up to the prescribed limit and within the agreed timeframe. For such a commitment, the IIFS pays a fee to the MDIC. The SAC recognizes the deposit insurance premium paid by the IIFS as the fee for the guarantee commitment, and that the fee belongs to the MDIC.

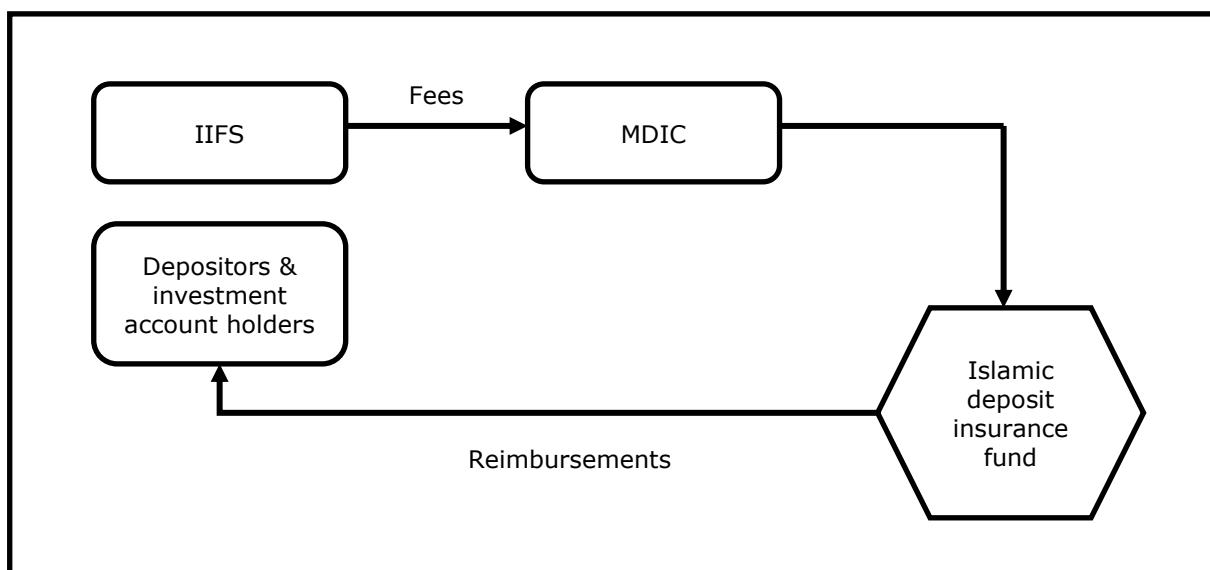
As regards the mechanism, there are several differences between Malaysia's kafalah bi al ujr model and the takaful model of Sudan and Jordan:

- (a) Unlike the takaful model, where the agreement is between the participants, the agreement under the kafalah bi al ujr model is between an IIFS and the deposit insurer;
- (b) Under the takaful model, all participants contribute to takaful funds, whereas under the kafalah bi al ujr model the IIFS pays a guarantee fee to the deposit insurer;

- (c) A deposit insurance fund under the takaful model is owned collectively by the participants that contribute to the particular fund, whereas under the kafalah bi al ujr model the fund belongs to the deposit insurer;
- (d) The reimbursement for insured deposits and investment accounts under the takaful model is made from the takaful funds, while reimbursement under the kafalah bi al ujr model is made from the deposit insurer's fund.

The mechanism of Malaysia's IDIS based on the kafalah bi al ujr model is illustrated in the following diagram.

Diagram 3: Malaysia's IDIS based on the kafalah bi al ujr model



The SAC did not raise the issue of excessive uncertainty (that is present under the conventional deposit insurance model) in an IDIS based on the kafalah bi al ujr model. While, on the surface, the conventional model and the kafalah bi al ujr model are similar in that a payment is made for a financial guarantee, they are different as far as Shari'ah is concerned.

As mentioned earlier, conventional deposit insurance is arguably a sale contract. It involves a purchase of a financial guarantee in that a bank pays a deposit insurance premium for the deposit insurer to reimburse the bank's depositors in the event of the bank failure. Shari'ah prohibits the transaction due to the uncertainty of obtaining reimbursement. By contrast, deposit insurance based on the kafalah bi al ujr model is a guarantee contract. Although the majority of Shari'ah scholars prohibit the taking of fees for a guarantee contract, as this will transform the contract into an exchange or sale contract, some Shari'ah scholars, including the SAC, allow the payment of fees for a guarantee commitment¹⁰.

¹⁰ See Appendix 3 for the basis of the SAC's ruling on the adoption of the kafalah bi al ujr model for Malaysia's IDIS.

In terms of the coverage under Malaysia's IDIS, the SAC ruled that the MDIC is allowed to guarantee both Islamic deposits and investment accounts. Nevertheless, Malaysia's practice of guaranteeing investment accounts is different from the practice in Sudan and Jordan.

Sudan's SHAB and Jordan's Fatwa Council of Research and Studies ruled that IIFS must not contribute to a fund for the guarantee of investment accounts, so as not to invalidate the Shari'ah contracts underlying the investment accounts. Such contribution should be made by investment account holders themselves. In Malaysia, under the kafalah bi al ujr model, the MDIC provides a third-party guarantee for investment accounts and the SAC had no objection to the payment of guarantee fees by IIFS.

Under the kafalah bi al ujr model, the MDIC is also allowed to prescribe the amount that it will reimburse to insured depositors and investment account holders in the event of the winding-up of an IIFS. Additionally, the SAC concluded that the amount payable by the MDIC should consist of the principal amount plus profit which has been credited to the account, including profit declared but not yet credited up to the date of winding up.

For investment accounts, any investment losses will be deducted when deriving the outstanding amount payable to investment account holders when an IIFS is wound up. As regards investment profit that has not been declared, the SAC allows this to be guaranteed by the MDIC but it must not be given priority.

As deposit insurance premiums are considered to be fees, the SAC allows the MDIC to structure them in the form of an absolute or proportionate value. The fee is calculated by applying a prescribed rate to the total amount of Islamic insured deposits and investment accounts as of 31 December of the preceding assessment year.

From assessment year 2005 until 2007, the MDIC prescribed a flat rate for the fee calculation. However, in view of its mandate to promote sound risk management among IIFS, starting in assessment year 2008 the MDIC implemented a differential premium system (DPS) for the calculation of fees, so as to provide financial incentives for IIFS with sound risk management practices.

As regards fees contributed by IIFS, the SAC ruled that these must be segregated from the premiums paid by conventional banks and must not be accumulated into one single fund. The MDIC therefore established and administers the Islamic deposit insurance fund separately from the conventional deposit insurance fund.

The segregation of funds helps the MDIC to avoid commingling of funds between the Islamic and conventional deposit insurance systems, and prevent uncertainties on the Shari'ah compliance status of the premiums collected from IIFS. It ensures that non-permissible expenditures are not charged to the Islamic deposit insurance fund, and that the fund surplus is invested in Shari'ah-compliant instruments.

The SAC also decided that the segregation of funds should be followed through until liquidation, so as to ensure the correct allocation of rights and priorities in the payment of the protection. In this regard, in the event of an IIFS being wound up, the MDIC will utilize the Islamic deposit insurance fund to make reimbursements for insured deposits and investment accounts in a prompt manner.

If the fund does not contain sufficient resources to carry out reimbursements, the MDIC is not allowed to source additional funds from the conventional deposit insurance fund. Instead, it must seek external funding from the Government or market; such funding must be compliant with Shari'ah.

In the event of an IIFS failure, the MDIC will reimburse insured deposits and investment accounts based on the SAC's resolution on the priority of payments. Deposit and investment products of IIFS are structured according to different types of contracts, which have different legal consequences. The priority of repayment of deposits therefore depends on the contractual relationship concluded between depositors/investors and the Islamic member institutions. The SAC resolved that the MDIC must make payments for Islamic deposits first before making payments to investment accounts, as the failed IIFS has a direct responsibility towards depositors, but not to investment account holders.

It is critical for the MDIC to have the legal power to recover the amounts it has paid out for Islamic deposits and investment accounts in the event that an IIFS is wound up. This is to ensure that the depleted Islamic deposit insurance fund is restored for future reimbursements.

The SAC did not highlight any Shari'ah-based impediments in implementing recoveries under the kafalah bi al ujr model. It was of the view that the relative priority of the MDIC's claims against depositors' and investors' claims in obtaining a refund in the event of an IIFS being wound up will depend on the type of deposits and investment accounts for which the MDIC has made the payout. For instance, if the MDIC has made the payment for wadi'ah deposits, the MDIC's claim is considered equal to wadi'ah deposits, and so forth.

Summary of comparisons of IDIS approaches

The following table compares the IDIS models of Sudan, Jordan and Malaysia.

Subject	Sudan	Jordan*	Malaysia
Type of deposit insurance system	Fully fledged (Islamic)	Dual (Islamic and conventional)	Dual (Islamic and conventional)
Shari'ah model	Takaful (joint guarantee or solidarity)	Takaful (joint guarantee or solidarity)	Kafalah bi al ujr (guarantee with fee)
Endorsement	By the Shari'ah High Advisory Board of the Central Bank of Sudan	By the Fatwa Council of Islamic Studies and Research of Jordan	By the Shari'ah Advisory Council of the Central Bank of Malaysia
Contracting parties (for the guarantee)	IIFS, investment account holders, Ministry of Finance, Central Bank of Sudan	IIFS, investment account holders, and the Government, represented by the Ministry of Finance, which contributes to the capital on a pro rata basis by analogy with the conventional system	IIFS and deposit insurer i.e. MDIC
Role of deposit insurer	BDSF as agent to manage takaful funds based on wakalah bi al ujr (agency with fee)	JODIC as agent to manage Islamic fund based on wakalah bi al ujr (agency with fee)	Guarantor
Fund providers	The takaful fund for the guarantee of deposits is contributed to by IIFS, the Ministry of Finance, and the Central Bank of Sudan. The takaful fund for the guarantee of investment accounts is contributed to by investment account	The takaful portfolio for the guarantee of credit accounts (Islamic deposits and uninvested portion of investment accounts) is contributed to by IIFS. The takaful portfolio for the guarantee of the invested portion of investment accounts is contributed to by	IIFS

Subject	Sudan	Jordan*	Malaysia
	holders, Ministry of Finance, and Central Bank of Sudan	the investors themselves – these premiums are to be paid by the IIFS on their behalf	
Establishment of deposit insurance fund	Two separate takaful funds for the guarantee of Islamic deposits and investment accounts	A separate Islamic fund is established with two portfolios: a takaful portfolio for credit accounts, and a takaful portfolio for investment accounts	Islamic fund separate from conventional fund
Owner of fund	Participants or providers of respective funds	IIFS and investment account holders; It should be noted the event of the fund's liquidation, the remaining balance will be transferred to the Zakat Fund after covering all losses and expenses incurred by the Islamic fund.	MDIC
Types of products covered	Islamic deposits and investment accounts**		
Amount payable upon reimbursement	Principal amount plus profit which has been credited to the account, including profit declared but not yet credited up to the date of winding up.		
Membership	Compulsory		
Expenditures	Permissible expenditures		
Investments	Shari'ah-compliant investments		
Reimbursements	Reimbursement for Islamic deposits and investment accounts is made from the respective takaful funds	Reimbursement for Islamic deposits and investment accounts is made from the relevant takaful portfolio	Reimbursement for Islamic deposits and investment accounts is made from the Islamic deposit insurance fund owned by the MDIC

Subject	Sudan	Jordan*	Malaysia
Deficiency in fund	Amounts may be withdrawn from the other takaful fund in the form of an Islamic loan. It is also allowed to source additional funds from the Government or market, based on Shari'ah principles	It is permitted to borrow funds in the form of a benevolent loan (qard hasan) from JODIC's conventional fund or from any third party	Withdrawals from the conventional fund are not allowed. Additional funds must be sourced from the Government or market, based on Shari'ah principles
Priority of payments	All Islamic deposits are ranked pari passu	All Islamic deposits and investment accounts are ranked pari passu	All Islamic deposits (i.e. wadi'ah, qard, murabahah and other debt-based deposits) are ranked pari passu but above investment accounts
Recovery from assets of failed IIFS	Allowed	Allowed	Allowed

* To date, Jordan's IDIS has yet to be operationalized.

** In Malaysia, investment accounts take various forms, such as saving accounts, current accounts, term accounts and negotiable instruments. Not all investment accounts are guaranteed by the MDIC – this is the case with negotiable instruments. In Jordan, restricted investment accounts are not covered under the IDIS.

Conclusion

In view of the non-permissibility of the model adopted for the conventional deposit insurance model, it is vital for policymakers to design Shari'ah approaches or models for IDISs. Among other things, the application of Shari'ah approaches ensures that the systems are compliant with Shari'ah rules and principles; builds confidence, among Muslim stakeholders especially, as to the permissibility of the systems; preserves the reputations of governments or deposit insurers; and promotes the effectiveness of the system.

In developing the approaches or models for an IDIS, Shari'ah scholars should be consulted and all relevant regulations by the authority must be considered. The system's design features need to be clearly presented to the scholars so as to allow a sound understanding of the features and their operationalization by deposit insurers, as well as to facilitate informed decision-making by the Scholars.

Shari'ah views on IDISs differ from one country to another depending on what is acceptable to the country concerned, and are well respected by other countries. This results in variations in models and approaches for the implementation of IDISs in different jurisdictions. All in all, it is key that the approaches or models adopted for IDISs help deposit insurers to implement effective IDISs for the protection of Islamic deposits and investment accounts, and to promote the stability of their Islamic banking systems.

Appendix 1

Concepts used for IDISs and their validity

Concepts	Validity
Tabarru'	<p>The concept of Tabarru' finds support in the Quran and Sunnah (the tradition of the Prophet pbuh). In many places in the Quran, Allah encourages Muslims to spend their fortune for the sake of Allah or seeking His pleasure. For example, in Surah al Munafiqun: 10: "And spend (in charity) out of that with which We had provided you before death befalls any of you. (If not) he (at that moment) will plead by saying: 'O my Lord reprieve me awhile so that I may give in charity and be among the righteous''. Allah had also praised the believers who had been rightly guided by Allah and who, among other characteristics: "believe in the unseen and are steadfast in prayer and spend out of what We have given them" (Al Baqarah: 3).</p>
Ta'awun	<p>The concept of ta'awun is drawn from the Quran, which states, "Help one another in goodness and piety, and do not help one another in sin and aggression" (Al Maidah: 2).</p>
Kafalah	<p>Kafalah, as a contract of guarantee, finds its legal basis in the Quran, Sunnah and Ijma or consensus of Muslim jurists. Among the strongest support is the story of Prophet Yusuf, who stood as the guarantor for a reward to whoever could return the King's bowl of measure. "They said: We had lost the (golden) bowl of the king and for him who produces it is (the reward of) a camel load and I will be the guarantor for it" (Yusuf: 72).</p> <p>A Sunnah further supports the validity and legality of Kafalah. It is narrated that the Prophet attended the funeral of a man to pray for his soul. He asked those who were present at the funeral: Did he leave any wealth? They replied: No. He asked further: Did he die with any debt outstanding? They replied: Yes, he owed two dinar. The Prophet was about to leave when he said: Then perform prayers on your companion. At this point Abu Qatadah said: I guarantee his debt, oh Messenger of Allah,</p>

Concepts	Validity
	and the Prophet then prayed for his soul. In another narration, the Prophet reported to have said: The guarantor is responsible.
Ujrah	<p>The legitimacy of Ujrah contracts is founded on the Quranic verses as well as the Sunnah. For example, the Quran directs a father to pay wages to a mother who suckles his child: "Then if they give suck to the children for you, give them their due payment" (Surah al Talaq:6). This verse indicates that it is an obligation on the father to provide adequate wages for women who breastfeed his child. Clearly it relates to the concept of Ujrah, where wages are given as consideration for hired services.</p> <p>In a tradition, the Prophet was reported to have said: "Pay the hired worker his wages before his sweat dries off". In addition, this practice has been established even from the pre-Islamic era and had been endorsed by the Prophet.</p>

Appendix 2

Fatwa relevant to the permissibility of insuring deposits held with Islamic Banks - Jordan Deposit Insurance Corporation (JODIC)

The General Ifta' Department issued its Fatwa no. (13/2012) dated 20 September 2012 regarding the permissibility of insuring deposits held with Islamic Banks. The Fatwa stipulates that:

"Deposits at Islamic Banks have features that are distinguished from conventional banks based on the differences of the types of accounts. Therefore, the Fatwa Council of Islamic Studies and Research reinforces the draft Law stipulating that premium fees paid to the Corporation against insuring the credit accounts shall be borne by the Islamic Banks, whereas the investment accounts' annual premium fees shall be borne by depositors with Islamic Banks. Thus, a separate Islamic Fund shall consist of two segregated portfolios that insure deposits at Islamic Banks: one portfolio for insuring credit accounts and the other portfolio for insuring investment accounts.

It is evident for the Council that the draft Law is based on Solidarity and Mutual Benefits (Takaful), and the Fund's financial resources shall be considered as a donation "Tabarru' Act" that aims at protecting depositors with Islamic Banks from risks. If the Fund is liquidated, the outstanding balance shall revert to the Zakat Fund at the Ministry of Awqaf, Islamic Affairs and Holy Places. Therefore, the Council considers the legitimate permissibility of establishing the Fund for Islamic deposit insurance and the soundness of proposed amendments on the draft Law and its compliance with the respective Shari'ah Principles. And God knows best."

Appendix 3

Validity of kafalah bi al ujr, by the Shari'ah Advisory Council of Bank Negara Malaysia

The majority of Shari'ah scholars are against the charging of fees for the kafalah contract, owing to the similarity with the sale contract discussed earlier for the conventional deposit insurance system. Nevertheless, the SAC took the view that such practice is permissible on the following basis:

- (a) Some contemporary Shari'ah scholars and Shari'ah Councils have resolved that the imposition of ujrah on kafalah is permissible. A few contemporary scholars further opined that ujrah charged on kafalah shall be permitted on the basis of maslahah and public needs because, in the current context, it is difficult and impractical to obtain a free-of-charge guarantee.

Moreover, one contemporary scholar, in his presentation to the OIC Fiqh Academy, had expressed his view that ujrah charged on dhaman (guarantee) is permissible. He was of the view that, although originally dhaman is a type of tabarru', the charging of ujrah on the dhaman is considered valid. He further stated that a dhaman contract is not considered as qard as it falls under the istithaq contract. Thus, receiving ujrah for the guarantee service is not prohibited as a dhaman contract is different from a qard contract; and

- (b) Qiyas on akhz al-ajr 'ala al-jah (to charge a fee for someone's reputation) and akhz al-ju'l 'ala ruqyah min al-Quran (to charge fee on the treatment/medication using Quranic verses). Some classical scholars permitted the imposition of fees in both situations, and this permissibility could be extended to the imposition of ujrah on guarantees as both have similarities in terms of the services provided.

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