

CONCEPT OF DEPOSIT INSURANCE IS APPROPRIATE FOR MUDHARABAH INVESTMENT

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Islamic deposit insurance is a system that operates in accordance with Shariah principles, and provides protection to depositors against loss of insured Islamic deposits placed with Islamic member institutions in the unlikely event that an Islamic member institution is unable to meet its financial obligations.

In 2003, substantial progress was made towards finalizing the features of the proposed deposit insurance system for Malaysia. Its main objective is to further strengthen incentives for financial systems to adopt sound financial and business practices and enhance public confidence in the financial system by providing explicit protection of deposits.

In September 2005, Malaysia has successfully implemented the deposit insurance system.

20 Elements of the design features

2.1A legislated mandate for the agency responsible for the administration of the deposit insurance system. In this case, the agency that has been accorded with the statutory powers is Perbadanan Insurans Deposit Malaysia (PIDM) or Malaysia Deposit Insurance Corporation (MDIC).

2.2Compulsory membership for commercial banks (including subsidiaries of foreign banks operating in Malaysia), finance companies (licensed under the Banking and Financial Institutions Act 1989) and Islamic banks (licensed under the Islamic Banking Act 1983)

2.3Protection up to the prescribed limit of RM60,000 for all depositors of member institutions.

2.4 Depositors with deposits in more than one member institution will be insured separately for their deposits in each institution. Joint, trust, sole proprietorship and partnership deposits will also be separately insured

2.5 Islamic and conventional deposits will be separately insured up to the deposit insurance limit to avoid any competitive distortions between the two banking systems

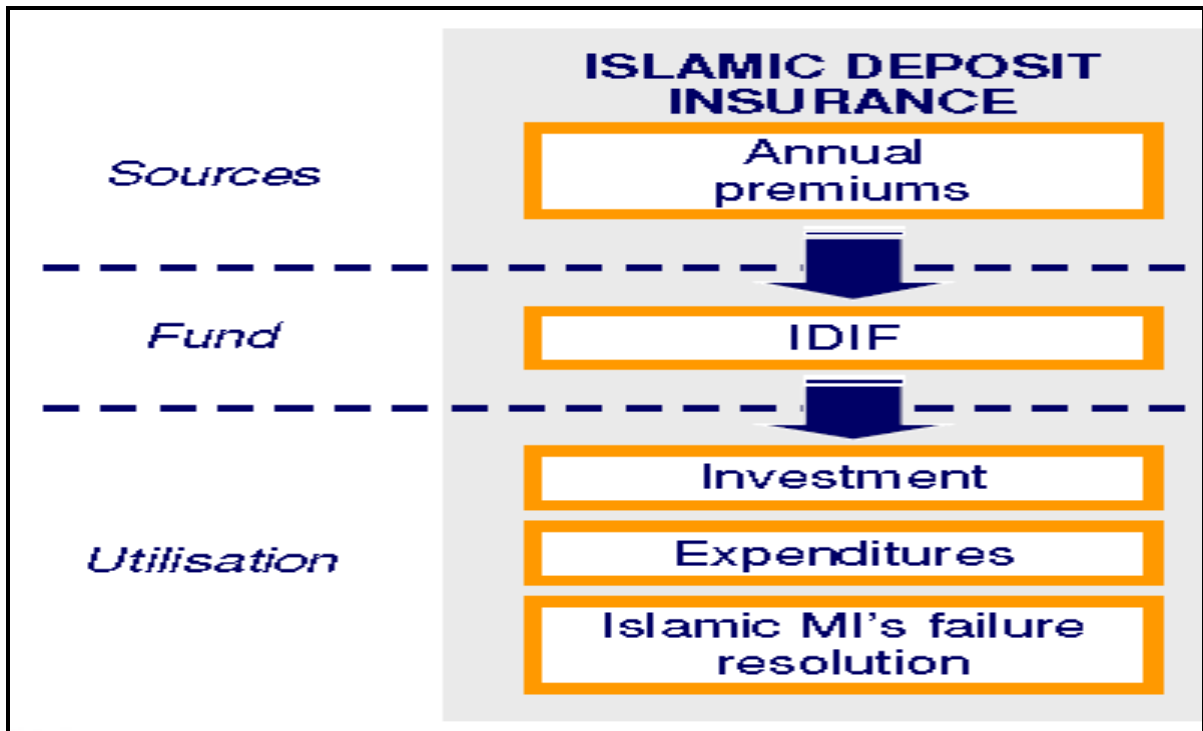
2.6 Annual premium to be paid by member institutions to the deposit insurance fund to be based on the institution's total insured deposits

2.7 The implementation of differential premium system to determine the premiums payable by each member institution, depending on the practices of member institutions. If their practices increase the risk of loss to the deposit insurance system, they will have to pay higher premium rates

3.0 Operation and mechanism of Islamic Deposit Insurance in Malaysia

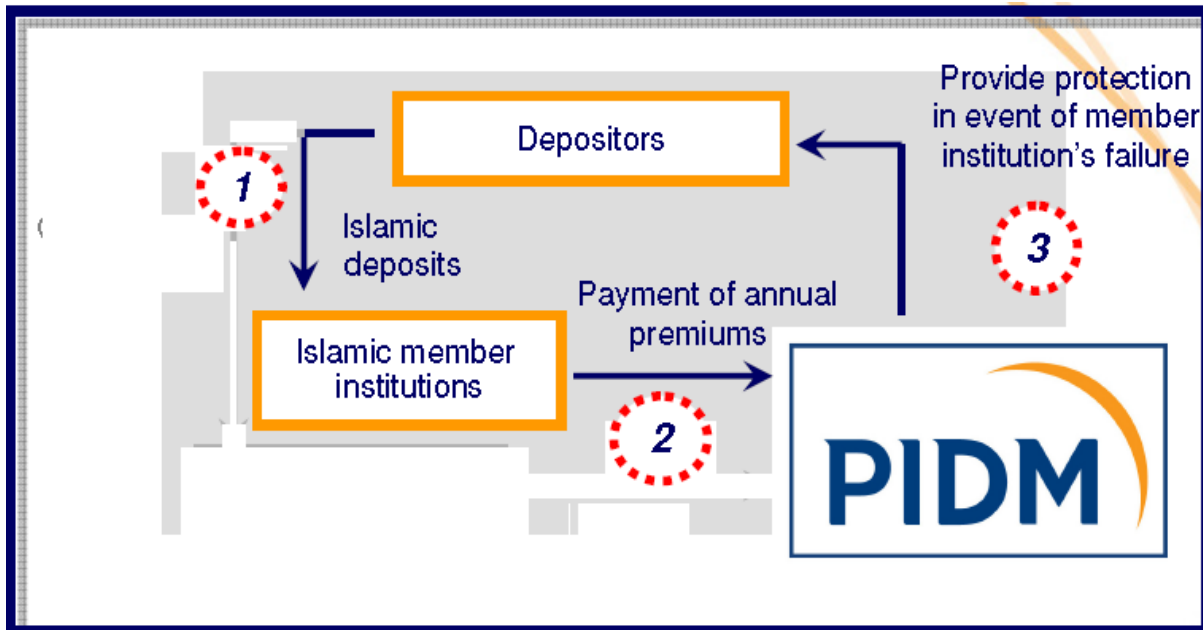
Bank Negara Malaysia (2008) has provided the framework on the operations and mechanism of Islamic Deposit Insurance in Malaysia and they are reproduced in Diagrams 1 and 2 below.

Diagram 1 : Operation of Islamic Deposit Insurance



Source : Bank Negara Malaysia (2008)

Diagram 2 : Mechanism of Islamic Deposit Insurance



Source : Bank Negara Malaysia (2008)

4.0 Recent news report on deposit insurance

The excerpts below are taken from The Star (<http://www.biz.thestar.com.my>) :

KUALA LUMPUR: The Malaysian government will **fully guarantee**, with immediate effect, all ringgit and foreign currency **deposits** with commercial, **Islamic** and investment banks regulated by Bank Negara.

Bank Negara and the Ministry of Finance said in a joint statement the guarantee also extended to deposit-taking development financial institutions regulated by the central bank.

It said the deposits would be fully guaranteed by the government through Perbadanan Insurans Deposit Malaysia (PIDM) until December 2010.

“The guarantee extends to all domestic and locally incorporated foreign banking institutions; and access to Bank Negara’s liquidity facility will be extended to insurance companies and takaful operators regulated and supervised by the Bank,” it said.

Bank Negara said the government was taking pre-emptive measures, which were consistent with regional initiatives to preserve confidence in respective financial systems. It added these measures were to maintain the stability of the Malaysian financial system.

5.0 Issue : Can Mudharabah deposits be insured under the MIDC scheme?

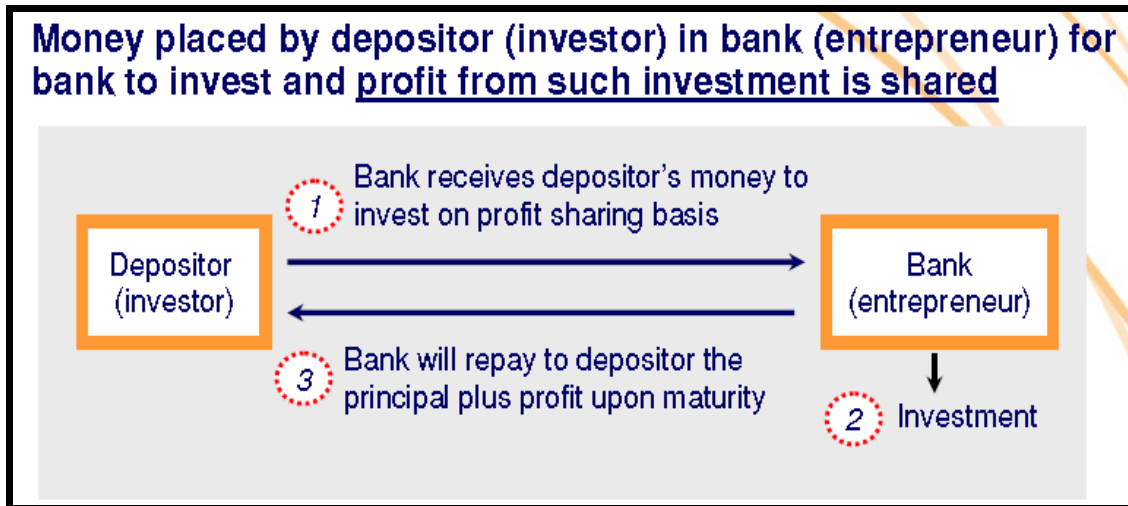
5.1 What are Mudharabah deposits?

Mudharabah is a form of profit/loss-sharing partnership between two parties in a commercial enterprise. The capital comes from the first partner (the fund provider) who is called the Rabb-ul-mal, while the second partner (the entrepreneur) is called the Mudarib.

Deposit-based products that are common in the market are the Mudharabah General Investment Account-i and Mudharabah Special Investment Account-i. Losses, if any, are to be solely borne by the depositor unless there is gross negligence on the part of the bank. In Malaysia,

there is no capital protection for the depositor (save for “capital protection” under the MDIC scheme). The concept is illustrated in Diagram 3 below.

Diagram 3 : Mudharabah deposit



Source : Bank Negara Malaysia (2008)

5.2 Why the need to establish Islamic deposit insurance?

According to International Association of Deposit Insurers (IADI) in their Research Letter (Vol 1 Issue 3 dated 18/7/2006), Islamic banks are also exposed to bank-run risks when the financial system loses public confidence. Deposit insurance systems – whether they are explicit or implicit – can play an important role in mitigating bank-runs and thereby promote financial stability.

The same comment was made by PIDM general manager, insurance, risk assessment and monitoring, Md Khairuddin Arshad in the BERNAMA News, the excerpts of which are reproduced below :

He said the level of insured deposits -insured by PIDM under the deposit insurance system - as at Dec 31, 2007 amounted to RM191.5 billion of which conventional deposits amounted to RM169.8 billion and Islamic deposits RM21.7billion.

Commenting on the Islamic deposit insurance, he said it was a system that provides protection to depositors against the loss of insured deposits placed with an Islamic member institution or in the unlikely event that it is unable to meet financial obligations.

The Islamic deposit insurance operates in accordance with Shariah principles.

Md Khairuddin said the Islamic deposit insurance was also needed to ensure the competitiveness of the Islamic banking system vis-a-vis conventional banking.

“It is also to **instil public confidence and promote financial stability**,” he explained.

5.3 Shariah issue

In Islamic banking, the implementation of deposit insurance scheme is equally important to ensure that the Islamic banking deposits are able to compete with the conventional deposits in attracting customers. The main issue here is whether Islamic banking institutions can apply the same facility.

The Shariah Advisor Council of Bank Negara Malaysia in its 26th meeting held on 26th June 2002 / 15th Rabiul Akhir 1423 resolved that deposit insurance scheme in Islamic banking is permissible based on the concept of mutual guarantee (*kafalah*) among the Islamic financial institutions as participants to the scheme. The implementation of deposit insurance scheme does not contradict with the Shariah principles since its objective is to protect the public interest especially the depositors and the banking industry as a whole.

Nevertheless, there is a need to separate the funds in the operation of deposit insurance scheme for Islamic banking to ensure that the funds of Islamic deposit insurance scheme are invested in Shariah compliant instruments

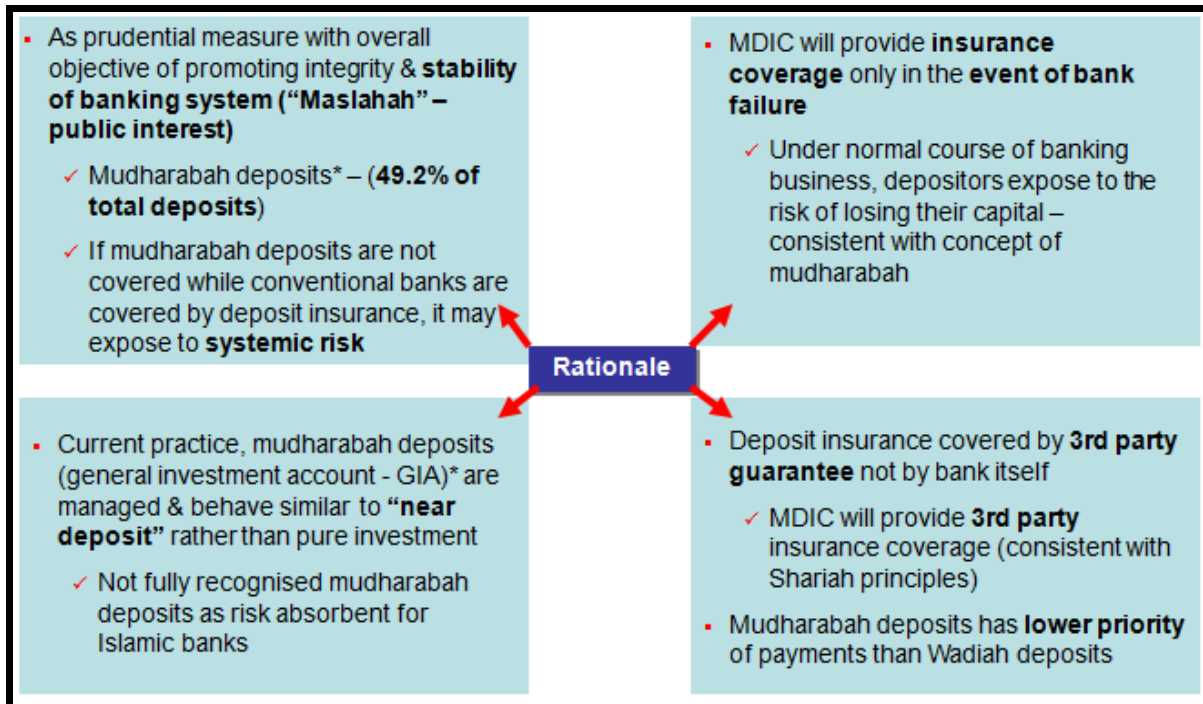
A fatwa issued by Arab Institute of Islamic Banking clearly stated that **“it is not permissible for the Bank, as the director of the funds to guarantee the shares of the participants if the Bank itself established and manages profit-sharing funds and Clearance funds”**. The Institute also issued another fatwa which states that **“guarantee from a partner to another partner is not permissible, if the guarantee forms part and parcel of the partnership contract. However, if the guarantee is concluded separately, without any connection to the contract of partnership, it is permissible. The same applies to a profit-sharing contract or an agency contract by investing”** (source : <http://www.isra.my>)

6.0 Conclusion

Based on the rulings (fatwa) specified in para 5.3, we could safely say that mudharabah deposit can be insured under the MDIC scheme. This is because MDIC, as the guarantor, is not a party to the partnership between the fund provider (depositor) and the Mudarib (Bank).

Given the permissibility of Islamic Deposit Insurance on mudharabah deposits, Bank Negara Malaysia has launched and summarized its rationale for its stand as illustrated in Diagram 4,

Diagram 4 : Rationale on insurance coverage of mudharabah deposits



Source : Bank Negara Malaysia (2007)