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بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

DEPOSIT INSURANCE SCHEME: A
COMPARATIVE STUDY BETWEEN
CONVENTIONAL AND ISLAMIC BANKING

BY

CHAIBOU ISSOUFOU

INTERNATIONAL ISLAMIC UNIVERSITY
MALAYSIA

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A dissertation submitted in partial fulfilment of the
requirements for the degree of Master of Comparative
Laws

Ahmad Ibrahim Kulliyah of Laws
International Islamic University
Malaysia

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ABSTRACT

This study is a comparative study between conventional and Islamic banking deposit insurance scheme. First of all, it discusses the historical development of deposit insurance. The study examines practices in Malaysia in relation to deposit insurance that include its role in banking and financial stability. The study discusses also application of deposit insurance in conventional and Islamic banking as well as its coverage limit and types of eligible deposits accounts. At the same time, it highlights the concept of *kafālah* as well as liability of entrepreneur to loss and damage. The study also highlights similarities and dissimilarities between conventional and Islamic deposit insurance, and deposits accounts operations of conventional and Islamic banking. Then, it examines and analyses the principles of conventional and Islamic deposit insurance in term of concepts and operations. Finally, it provides suggestions for an alternative Islamic banking deposit insurance to the existing conventional one.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of master of Comparative Laws.

.....
Uzaimah Ibrahim
Supervisor

I certify that I have read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of master of Comparative Laws.

.....
Ahmad Azam Othman
Examiner

This dissertation was submitted to the Department of Islamic Law and is accepted as a partial fulfilment of the requirements for the degree of Master of Comparative Laws

.....
Najibah Mohd Zin
Head,
Department of Islamic Law

This dissertation was submitted to the Ahmad Ibrahim Kulliyah of Laws and is acceptable as partial fulfilment of the requirements for the degree of Master of Comparative Laws.

.....
Zaleha Kamarudin
Dean, Ahmad Ibrahim
Kulliyah of Laws

DECLARATION PAGE

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Chaibou Issoufou

Signature

Date.....

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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**DEPOSIT INSURANCE SCHEME: A COMPARATIVESTUDY BETWEEN
CONVENTIONAL AND ISLAMIC BANKING**

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This work is dedicated to all my parents, all my family members and all Muslim brothers especially Law students and those who want to specialize in Islamic banking and finance.

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In the name of *Allah*, Most Gracious, Most Merciful. All praise is for *Allah subbahānahu wa ta'ālā* and blessings and salutations of peace be upon His Messenger Muhammad *ṣallallāhu alaihi wasallam* and his companions and those who follow them in upholding the cause of the right religion. For the first time that I sat down to attempt to write my dissertation, I realize that it would not be an easy task for me. This is because my secondary school education and first degree used the Arabic language.

Thus, when I came to this University I started to learn English from scratch (level one). I also faced some difficulties due to shortage time as well as materials, particularly in this area of research. However, after I have completed this dissertation, I would like to thank International Islamic University Malaysia and Ahmad Ibrahim *Kulliyah* of Laws for granting me the opportunity to join this course. My appreciation and thanks to every person who has helped me directly or indirectly, particularly to my lecturers in this *Kulliyah*. It is a great pleasure to express my profound gratitude and thanks to my supervisor Dr. Uzaimah Ibrahim for her sincere supervision, as without her physical and moral support, this work cannot be achieved at the moment. A special thanks from the deepest of my heart goes to Dr. Ahmad Azam Othman for his sincere examination and supervision, as without his sincere examination, this work cannot be in the appropriate way.

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Folley v Hill [1848] 2HLcas 28

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Banking and financial Institutions Act 1989
Canada Deposit Insurance Corporation Act 198
Islamic banking Act 1983
Jamaica Deposit Insurance Act 1998
Malaysia Deposit insurance Act 2005
Takāful Act 1984

LIST OF ABBREVIATIONS

BIMB	:	Bank Islam Malaysia Berhad
BAFIA	:	Banking and Financial Institutions Act
DIB	:	Dubai Islamic Banks
FDIC	:	Federal Deposit Insurance Corporation
FSLIC	:	Federal Savings and Loans Insurance Corporation
FSF	:	Financial Stability Forum
KFH	:	Kuwait Finance House
IBA	:	Islamic Banking Act
IBB	:	Islamic Bank of Bahrain
JIB	:	Jordan Islamic Bank
MDIC	:	Malaysia Deposit Insurance Corporation

CHAPTER ONE

INTRODUCTION

1.1 PREFACE

Deposit insurance scheme is established to provide some form of protection to depositors who stand the risk of losing their hard earned money in the event of bank failures. Therefore, the agency guarantees deposits in the insured institutions and stands ready to reimburse depositors promptly in the event of the insured bank's failure. The practice of deposit insurance differs from one jurisdiction to another. Over the years, however, some good practices have emerged to guide countries that have established deposit insurance scheme or countries wishing to establish deposit insurance scheme. Essentially, the practices of deposit insurance scheme deal with the issues of ownership or administration, membership, funding, coverage, pricing and failure resolution.¹

Deposit insurance scheme differs from general forms of conventional or commercial insurance in the way that it is profit oriented and only serves to safeguard the property of an individual. Deposit insurance, however, is a safety net vehicle designed to stabilise financial systems and safeguard the rights and interests of depositors in financial institutions by encouraging cooperation between the government and businesses in relation to the provision of credit. It is not profit oriented. In addition, deposit insurance serves to guard against financial loss to an appropriate degree. In other words, deposit insurance does not merely passively wait

¹G. A. Ogunleye, OFR, "*Concept and Relevance of Deposit Insurance in Africa*", paper presented at the 10 Meeting of the Committee of Banking Supervisors of West and Central Africa, Thursday, 9th September, 2006
<<http://www.ndic-ng.com/pdf/dismdpaper.pdf/IADI>> (accessed on 16 September, 20)

for a catastrophe to happen before providing compensation, but adopts all kinds of preventive measures to promote sound operations of insured institutions. This is where deposit insurance scheme and commercial insurance in general fundamentally differ.²

Moreover, deposit insurance scheme is usually mandated by law. Whether membership is compulsory or voluntary, the law classifies types of financial institutions and deposits which are eligible for insurance. The law specifies the maximum amount of insurance coverage and how the fund is going to be financed as well as the modes by which the deposit insurer can resolve failing bank situations. The cost of operation is normally covered by premiums paid by member banks.³

The role of deposit insurance in the financial sector has been heavily studied in academic circles recently. The consensus view of academics on the role of financial intermediaries is that they serve at least two primary functions. First and foremost, they are generators or creators of deposits. These deposits are obtained from either the government, to finance deficits, or from the private sector. In fact, their value to the economy rests primarily on their ability to screen and finance wealth enhancing projects in the economy. The second role normally enumerated is the channelling of savings resources to a higher purpose. This is achieved in two distinct ways. For transaction balances, the financial sector has developed the capacity to use idle balances, even while the payment system functions efficiently. From the perspective of the institution, it provides depository services as a mechanism to finance the lending activity. To the economy as a whole, the payment system that results from this process is a central part of the financial infrastructure. In short, the institutions offer

²Ibid.

³see Early Warning Indicators, *Deposit Insurance and Methods for Resolving Failed Financial Institutions*, edited by Delano Villaeuva (Kuala Lumpur, Malaysia: The SEACEAN Research and Training Centre, 1998), 30

standard financial assets to the public which must be priced efficiently in financial stability and depositors' protection.⁴

Among Muslim scholars and policymakers, there is an increasing interest on the need of adopting a deposit insurance scheme into Islamic banking. In this regard, Zakariya Othman, editor of the Islamic Finance News stated that the fundamental distinction of an Islamic bank is the lack of the deposit insurance common in conventional banks. Calls have been made for initiatives to help protect deposits against such risk, and several Muslim scholars think that deposit insurance scheme should be an integral part of the Islamic banking system. As a result, the Turkish government has embarked on this and has emerged as leader in pushing for protection of depositors in Islamic banks. It has allowed Islamic banks to set up a parallel Islamic deposit insurance scheme, which is similar to its conventional counterpart in everything except that the Islamic scheme only invests the deposit insurance pool according to Islamic investment principles. The scheme, introduced in July 2003, was the first Islamic deposit insurance scheme in the world, and was followed by Malaysia in September 2005.⁵

In addition, the operation of conventional deposit insurance scheme now exists in almost all developed countries and an increasing number of developing countries. It serves a number of important economic and social objectives, the principle being the provision of protection to small, unsophisticated depositors, the maintenance of

⁴Anthony M. Santomero, *Deposit Insurance: Do We Need It and Why?* Wharton Financial Institution Center at Wharton School, University of Pennsylvania,3-4

<<http://fic.wharton.upenn.edu/fic/papers/97/9735.pdf>> accessed on 16 September, 2007

⁵International Association of Deposit Insurers (IADI) "clp date on Islamic Deposit Insurance (Basel :IDI) July 2006 vol 1 Issue 3,4

<http://www.iadi.org/Research%20Letters/IADI_ResearchLetter_Vol1_Iss3pd (accessed on 9 July, 2007)

confidence in the stability within the financial sector and the acceleration of the process of failure resolution strategies in cases where a bank fails.

Deposits accounts cater for monies that depositors put into a bank for safe keeping or investment purposes. The types of Islamic deposit accounts are similar to conventional deposit accounts.

1.2 SIGNIFICANCE OF RESEARCH

The operations of Islamic deposit insurance scheme are still at its initial stages compared to conventional deposit insurance scheme, which have been rooted in economic and banking system since 1829 in New York State.⁶

In Islamic banking, structural and operational design features of Islamic deposit insurance systems should comply with the principles of *Shari'ah*. Based on the basic understandings of Islamic banking, it is worthwhile to take a look at some key issues for deposit insurers under an Islamic banking system and the different features compared to those for conventional deposit insurers. For those who are considering the adoption of new Islamic deposit insurance system, or the reform of an existing deposit insurance system, it is worthwhile to pay special attention to the following issues:

Constitution of the Islamic deposit insurance system: the study looks into the issue of constitution of Islamic deposit insurance system and its compliance with *Shari'ah* principles.

Coverage: types of deposits which are covered under the deposit insurance system. This includes investment deposits accounts; limitation of the deposit insurance under an Islamic deposit insurance system and how this limit is applied; if a

⁶*Federal Deposit Insurance Corporation, Annual Report*(Washington D.C. 1984), 22

country has already established conventional deposit insurance system, is the insurance coverage limit per depositor under Islamic deposit insurance comparable or equal to the limit of the conventional deposit insurance system?

Funding: funding mechanisms which are available to deposit insurers in compliance with *Shari'ah* principles; deposit insurance that can be managed without contradicting *Shari'ah* principles and assessment scheme which is more appropriate to the Islamic deposit insurance system.

Bank closure and failure resolution: Once an insolvent bank has been identified, existence of a process for handling that bank and a deposit insurer's role in the process.⁷

Therefore, by looking deeply into the above issues a clearer picture on the concept and operational practice of Islamic deposit insurance scheme will emerge.

1.3 HYPOTHESIS OF RESEARCH

Nowadays, the operation of deposit insurance scheme plays an important role in contemporary banking and financial systems as it provides protection against financial loss due to bank failure. However, the practice of deposit insurance systems in Islamic banking in its current form needs to be studied in depth, with analysis and elaboration. Thus, Islamic banking system should differentiate its practices from conventional banking system in order to have a pure Islamic banking and finance. It is believed that Islamic deposit account which is based on the concept of safe keeping with guarantee (*wadi'ah yad damānah*), has already guaranteed. Therefore, there is no need for deposit insurance in the former, while *muḍārabah* account may have the deposit insurance, but subject to strict conditions.

⁷IADI, 3-4

1.4 OBJECTIVE OF RESEARCH

It was found that most Muslims hold the view that conventional insurance contravenes the principles of *Shari'ah* as it contains unlawful elements of interest (*ribā*), gambling (*maysir*) and uncertainty (*gharar*). Nevertheless, most Islamic banks have intention to implement deposit insurance scheme while others have already implemented it. As a result, this research aims to propose *Shari'ah* compliant deposit insurance scheme between Islamic and conventional banks. These objectives could be achieved by analysing the principles of *Shari'ah*.

The research aims to find out whether Islamic deposits accounts like current accounts and saving accounts which are safe custody with guarantee (*wadi'ah yad damānah*) should be insured. Thus, even in Islamic banking, insolvency risks cannot be ruled out, notably in cases where banking operations are carried out according to a two-tiered *muḍārabah* arrangement. Moreover, under certain circumstances, even demand deposit may not be guaranteed as to its par value when bank's soundness deteriorates by poor investment decisions. Hence, Islamic banks are also exposed to bank-runs risks when the financial system loses public confidence. As a result, deposit insurance systems, whether they are explicit or implicit can play an important role in mitigating bank-runs and thereby promote financial stability.⁸

The challenges of Islamic banking in contemporary financial sector should give its incentive to have acceptable deposit insurance whereby it can promote its financial development in the world. Therefore, this research aims to find out whether deposit insurance scheme can conform to the *Shari'ah* rules, and examine the rules of *Shari'ah* which can deal with the deposit insurance scheme.

⁸Ibid, 3-4

Furthermore, the research also aims to assess the future prospect of deposit insurance scheme and its role in contemporary Islamic banking and finance development.

1.5 METHODOLOGY OF RESEARCH

The research will be conducted by collecting data from available primary and secondary sources such as statutes, cases, books, encyclopaedia, journals, seminar, conference papers and internet materials.

An interview will be conducted with the staff of the Malaysia Deposit Insurance Corporation (MDIC) and the *Shari'ah* Advisory Council of Bank Negara Malaysia. The aim of this interview is to assess and collect data on the performance and challenges faced by Islamic banks and its deposit insurance scheme.

1.6 SCOPE AND LIMITATIONS OF RESEARCH

Basically, sources of funds in both conventional and Islamic banks can be grouped into four categories i.e. banking funds, customers' deposits, corporate banking activities, and treasury activities or placements. However, this research mainly focusses on customers' deposits such as demand deposits (current and saving accounts), general and special investment deposits. In Islamic banking, demand accounts are normally based on safe custody or safe keeping (*wadi'ah*) or benevolent loan (*qard hasan*) contracts, while general and special investment accounts are based on profit sharing (*muḍārabah*). The research however, does not extend to leasing (*ijārah*), mark-up sale (*murābahah*), partnership (*mushārahah*), negotiable instrument deposits accounts, money market deposits accounts, buy and sale back (*bay al- 'inah*) or sale with deferred payment (*bay bithaman ājil/BBA*). This research conducts as a

comparative study between conventional and Islamic practices in deposit insurance scheme from the perspective of *Shari'ah*. The research also covers deposit insurance practice particularly Malaysia.

1.7 LITERATURE REVIEW

Most accessible literature on deposit insurance mostly concentrates on conventional deposit insurance in general. There are very few materials available relating to Islamic deposit insurance. Therefore, the research intends to add to the literature on the general concepts and principles of deposit insurance transactions.

The following are works of scholars that deal with conventional deposit insurance scheme, i.e., books on deposit insurance that discuss the general principles of deposit insurance which were written by western authors.

George G.Kaufman in his book *Reforming Financial Institutions and Markets and Issues in the United States*, discusses in chapter 1 the history of the Federal Deposit Insurance Corporation Improvement Act of 1991.⁹ However, his discussion confines only on the historical background of the Federal deposits insurance in the U.S.A.

Mark S. Dorfman in his book *Introduction Risk Management and Insurance*, discusses in chapter 6 on consumer protection, the role of the courts, the law, and the insurance commissioner.¹⁰ Though this chapter is not relevant to deposit insurance, it is useful for consumer protection, which is one of the objectives of deposit insurance schemes.

⁹George G. Kaufman, *Reforming Financial Institutions And Markets And Issues In The United State*,(London : Kluwer Academic Pulishers), 1-2

¹⁰Mark S. Dorfman, *Introduction To Risk Management And Insurance*, 8th Ed (Upper Saddle River New Jersey ,2005),118

Allin F. Cottrell, Michael S. Lawlor, John H. Wood in their book *The Causes and Costs of Depository Institution Failures*, comment in chapter 7 comprehensively on the historical evidence of commercial bank failures in the United States in order to assess the validity of the widespread belief that deposit insurance has increased bank failures due to the moral hazard that it presents to bank management.¹¹ However, their discussion is confined only to historical evidence in Federal deposit insurance.

Furthermore, there are a few books that discuss on deposit insurance as regards to Malaysia, such as:

The Malaysia Deposit Insurance Corporation in its Annual Report Journal (2005) defines the main objective of deposit insurance system and its constitution, scope of coverage and payment to depositors in Islamic and conventional deposit insurance systems.¹² However, it does not explain how the issues mentioned above can comply with the principles of Islamic Law (*Shari'ah*). As a result, the theme needs further explanation and evaluation on the issues.

Maria L.Fres-Felix in her book *Deposit Insurance Schemes: Its Nature, Role And Issues* provides a comprehensive discussion on the nature, role and issues of deposit insurance scheme in England and Malaysia which is quite relevant to the subject matter.¹³ However her discussion on the theme is brief and limited in exposition. Therefore, there is a need for further elaboration on deposit insurance in order to have a clear understanding of the concept and practice of deposit insurance scheme especially the law pertaining to deposit insurance in Malaysia.

¹¹Allin F. Cottrell, Michael S. Lawlor, John H. Wood, *The Causes And Costs Of Depository Institution Failures*, (London :Kluwer Academic Publishers, 1995),162

¹²*Malaysia Deposit Insurance Corporation, Annual Report Journal (2005)*

¹³Maria L.Fres-Felix,*Deposit Insurance Schemes: Its Nature, Role and Issues* (Kuala Lumpur: SEACEN Research and Training Centre, 1991)

Lee Hock Lock in his book *Public Polices, Other Deposit Institutions in Malaysia* in chapter 2 discusses the protection of depositors' interests and how the legislative measures can regulate these matters: information; powers of the authorities to act and recognition of depositors' rights.¹⁴ This chapter is not relevant to deposit insurance. On the other hand, it can assist regarding the protection of depositors which is one of the objectives of deposit insurance scheme.

Jean Pierre Sabourin: Chief Executive Officer Of Malaysia Deposit Insurance Corporation in his paper discusses briefly on Establishing Effective Deposit Insurance System and its design in Malaysia. He attempts to assess the concepts of deposit insurance scheme in both conventional and Islamic banks and evaluates its development and its future prospects in Malaysia. He also has an overview on the position of deposit insurance system in Malaysia.¹⁵ However, his discussion needs further elaboration on establishment of deposit insurance system and its concepts in Malaysia.

In addition to the above sources Muslim scholars' works that deal with the subject matter are also relevant, such as:

Saad Abdul Sattar Harran in his book *Islamic Finance: Partnership Financing* in chapter 3, entitled 'Profit-loss-sharing' system examines analytically the framework for the profit-loss-sharing system called *muḍārabah*. The chapter is divided into seven sections. First, he discusses the economic and philosophical principles of Islam and banking under Islam. Second, he defines and explains *muḍārabah*, with a subsection that critically examines *muḍārabah* as a company, its legitimacy and prerequisites.

¹⁴Lee Hock Lock, *Public Polices, Commercial Banks and Other Deposit Institutions In Malaysia*, (Kuala Lumpur, Malaysia Umcb Publication, 1981), 9

¹⁵Jean Pierre Sabourin, *Establishing Effective Deposit Insurance Systems in Malaysia*, paper presented at the Global Islamic forum and Islamic Financial Services Board annual meetings and seminars in Kuala Lumpur Malaysia 27 March 2007.