

Role of Standard Setting Bodies in Promoting Sharia-Compliant Deposit Insurance System (DIS)

Islamic banking system holds a unique appeal for a large number of people across the globe. The phenomenal growth in the system for the past many years indicates its strong potential to influence, or even reshape, the global financial and economic landscape. As an effective Sharia-compliant alternative to the conventional banking, Islamic banking has a large niche in Islamic societies as well as in the global financial system. This segment of the society would not otherwise bank with the conventional banks because of their unbending faith considerations. The resultant financial exclusion puts a great strain on the ability of these people to play their potential role in the economic development process. By bringing on board this wide section of the Muslim population, a great number of countries, particularly with Muslim majority, can accelerate their economic development process by achieving deeper penetration of financial services through a sound and efficient Islamic banking system.

Over the recent years Islamic banks have shown phenomenal growth and their outreach shows heartening progress both in terms of the size of their balance sheet as well as the number of new customers brought into the formal saving mobilization channel of banking. In a recent study, International Monetary Fund has estimated that more than 300 Islamic financial institutions are operating across the globe, while Islamic banks manage more than USD400 billion assets with annual growth of 15% per annum. In Pakistan, the asset portfolio of the Islamic banks has grown at an annual compound growth rate of around 74 percent over the last four years. This nascent system of banking now accounts for around 3 percent of the total banking sector assets in Pakistan. Its contribution in bringing the new Sharia-conscious customers into the banking system has been even more remarkable.

Stability of the Islamic Banking System & Deposit Insurance :

While the consistent and fast growth in Islamic banking is not only encouraging but also crucial for erecting an imposing edifice vis-à-vis the well entrenched conventional banking system, the imperatives of ensuring financial soundness and stability nevertheless assume centre stage in the

face of rapid flux in financial markets, services, products and information technology. To present it as a viable and vibrant alternative, the Islamic banking will have to evolve on lines that are consistent with the diversified needs of financial markets, and develop the firewalls that shield it from unexpected shocks and upheavals. It gives a sense of satisfaction that stability concerns relating to Islamic banking have started to find more frequent resonance in policy dialogue among the regulators, supervisors and other key players and stakeholders. Endeavors are afoot to ensure the stability of this new yet promising Islamic banking regime. In this respect, a well-defined financial architecture, an enabling regulatory & legal infrastructure, transparent corporate governance practices, adequate market discipline, and effective regulatory oversight are identified as key factors so vital for the promotion of financial stability of the Islamic banking system.

The stability debate also brings to fore the importance of adequate safety nets in the form of Lender of Last Resort (LLR) and Deposit Insurance System (DIS) in developing confidence of the customers and stakeholders in the smooth functioning of the Islamic banking system and also to reduce the probability of crisis, and in the event of a crisis, its cost. LLR facility enable otherwise healthy banks to continue operations in the face of a liquidity crisis caused by public's increased demand for cash and are widely intended to protect the financial system as a whole. On the other hand, DIS focuses primarily to bail out financially insolvent individual banks as a means to protect their depositors. In fact DIS goes still further in augmenting the financial stability by instilling a sense of protection among the depositors about their money lying with banks. This protection is crucial in pacifying the likely over-reaction from depositors in the event of a slight distress – such panic on the part of depositors could readily precipitate a minor and manageable crisis into a full fledged financial crisis by creating bank runs.

A well-designed Sharia-compliant Deposit Insurance System (DIS) underscores its presence also because of the following unique features associated with the Islamic banking system:

Firstly, the depositor of an Islamic bank holds a status which is not that of a creditor in a conventional bank. The depositor in principle is a shareholder of the bank - sharing risk and reward under a Modaraba arrangement. In the event of a downturn in the bank, the depositor is likely to lose the money alongside shareholders. This fact makes the depositors of an Islamic bank more cautious about the protection of their money thus putting a greater pressure on the Islamic bank in the event of even minor distress. Their concern for the safety of their funds could create a bank-run situation in the event of a slight fragility in the bank and undermine the stability of entire financial system through a contagion effect. A Sharia-compliant DIS can effectively pacify such concern of the depositors.

Secondly, the unique asset-liability structure of Islamic banks poses relatively greater liquidity strain for them. Resultantly, the Islamic bank may fail to meet the demand of its depositors at par value, though this cannot be considered as financial insolvency. This peculiarity necessitates adequate safety net in the form of 'lender of last resort' and deposit insurance to ward off any banking crisis.

Thirdly, the infrastructure support for Islamic banks in terms of ancillary markets and products for effective liquidity management has yet to fully develop in most of the economies. This vulnerability exposes the banks to liquidity strains that in turn have the potential to generate bank-runs due to the bank's inability to honour its obligation due to impaired market liquidity.

DIS provides the explicit protection to the depositors against the loss of insured funds should a member institution fails to meet its financial obligation. An effective DIS contributes towards the financial stability by strengthening public confidence in the financial system. Under DIS the depositors have assurance that they will not lose their money in the event of a bank failure. This assurance acts as a strong mitigant against the risk of bank run which readily could undermine general confidence in entire banking system. Therefore, the implementation of an effective Sharia-compliant DIS is strongly advocated for financial stability of Islamic Banking system.

However, DIS is not free of certain pitfalls. It has the potential to act as a double edge sword - especially when the design and structure features of the system are inconsistent with the best standards and principles and the macro environment situation in the realms of economic

condition, structure and state of banking system, expectation and attitudes of general public, legal framework, regulatory regime, disclosure requirement and market discipline. Such a system creates the problems of moral hazard and weakened market discipline. Moral hazard refers to the incentive for excessive risk taking on the part of protected institutions. And a sense of protection to the depositors induces them to lower their vigilance on the performance and soundness of banks. These downsides of the deposit insurance distort the incentive structure and could even aggravate the emergence of a financial crisis through increased risk-taking appetite and weakened market discipline. However, these downsides of the deposit insurance can be addressed by incorporating the best practices and principles in the design and structure features of the system.

Country Practices on Sharia-Compliant Deposit Insurance System:

The concept and framework of Sharia-compliant DIS is still in its formative phase. Islamic deposits in most of the regimes lack the protection of formal Sharia-consistent deposit insurance. There are still only a few economies that offer explicit Sharia-compliant DIS to the Islamic depositors. Pioneering lead in the field was provided by Turkey when in 2003 Islamic banks were allowed to setup deposit insurance. The scheme was similar to its counterpart covering conventional banks; the only distinction was that Islamic deposit insurance pool fund was invested in line with Islamic principles of finance. This initiative was followed by Malaysia by setting up a separate deposit insurance mechanism for Islamic deposit in Malaysian Deposit Insurance Corporation (PIDM) – a deposit insurer offering an elaborated Sharia-consistent deposit insurance to Islamic deposits in the country. As per a recent research of International Association of Deposit Insurance, a number of other countries such as UAE, Qatar, Iran, Saudi Arabia and Pakistan have significant volume of Islamic banking in their economies. However, they do not have explicit Sharia-compliant insurance schemes. Some of these countries have rather resorted to implicit approach of deposit insurance but there is no formal regulation explaining the scheme.

Standard Setting Bodies & Their Role in Promoting Financial Stability in Islamic Financial System :

Efforts and initiatives for ensuring the stability of the Islamic Banking System demand utmost excellence. These should comply with the best

standards and practices as well as the tenets of Sharia. Fortunately, there already exist a comprehensive framework of standard setting bodies and regulatory forums for guidance on best standards and practices as well as the Sharia principles. Namely, we have with us following bodies for the guidance and promotion of Islamic finance and banking:

1. **Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)** prepares accounting, auditing, governance, ethics, and Sharia standards for Islamic financial institutions. It has issued standards on accounting, auditing, governance, ethical, and Sharia standards. Besides, the organization organizes seminars on key regulatory and Sharia issues. It has also planned a Certified Islamic Public Accountant (CIPA) program for accountancy education.
2. **Islamic Financial Services Board (IFSB)** serves as an international standard setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry. It focuses on introducing new, or adapting existing international standards consistent with Islamic Sharia principles, and recommends them for adoption. So far the board has developed and issued guiding principles on corporate governance, risk management and capital adequacy standards for Islamic financial institutions. The board also arranges summit / conferences / workshops on various issues relating to Islamic banking.
3. **International Islamic Financial Market (IIFM)** aims to ensure the continued growth of Islamic banking and finance as a viable alternative to the conventional financial system.
4. **Liquidity Management Centre (LMC)** seeks to develop an active secondary market for short-term Sharia compliant treasury products so as to facilitate the Islamic financial institutions effectively manage their asset liability mismatch and assume term risk, securitize and liquidate such assets to improve the quality of their portfolios.
5. **Islamic International Rating Agency (IIRA)** is primarily concerned with rating of sovereigns, entities, and issues particularly in Islamic

countries. Basic aim is the assessment of compliance with the Sharia principles.

6. **General Council of Islamic Banks and Financial Institutions** focuses on the media and awareness, information and research, policies and strategic planning, and Islamic financial products.
7. **Arbitration and Reconciliation Centre for Islamic Financial Institutions** aims to settle financial and commercial disputes between financial or commercial institutions that have chosen to comply with the Sharia to settle disputes. It also settles disputes between these institutions and third parties through reconciliation and arbitration.

In addition to these bodies which specifically work for the promotion of Sharia-compliant financial services there are bodies that are working for ensuring the global financial stability. **Bank for International Settlement (BIS)** and **International Monetary Fund (IMF)** are such leading institutions. Housed in the BIS is **Financial Stability Forum** that brings together national authorities responsible for financial stability in significant international financial centers, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The forum has issued 'Guidance for Developing Effective Deposit Insurance Systems'. The guidance is expected to benefit countries which are considering the adoption or the reform of an explicit, limited coverage deposit insurance system. Realizing the importance of Sharia compliant deposit insurance, **International Association of Deposit Insurers (IADI)** has also formulated a dedicated Islamic Deposit Insurance Committee for carrying out research for its members and other stakeholders. The committee is expected to issue guidance and principles for setting up effective Sharia compliant deposit insurance systems. Then there are a number of international standard setting and regulatory bodies such as **Basel Committee on Banking Supervision (BCBS)**, **International Accounting Standards Board (IASB)**, **International Association of Insurance Supervisors (IAIS)**, and **International Organization of Securities Commissions (IOSCO)** making contributions in their respective realms.

These bodies have put forth extensively searched and empirically established standards and best practices that are imperative for a transparent, effective and sound financial system. While making different

decisions involved in the process of establishing and operating an effective Sharia-compliant DIS, the policymakers could draw on the work of these standard setting bodies and regulatory forums.

Major Issues in Sharia-Compliant Deposit Insurance System & Role of Standard Setting Bodies :

The development and operation of a Shari-compliant DIS requires well thought-out strategy and action plans. There are a number of questions that would arise while deciding upon different aspects of a Sharia-compliant deposit insurance system. These issues basically relate to the following two main policy concerns: -

- The Deposit Insurance System, in entirety, should be compliant with Sharia tenets, and
- The system should fulfill all the necessary requirements for ensuring effectiveness in the realization of policy objectives. This concern is equally important because a poorly designed system could not only fail the intended objectives but also add to financial instability by creating the problems of Moral Hazard and weakened Market Discipline.

It has been empirically established that an adequate macro environment is imperative for the success of a DIS. There should be an enabling legal, regulatory, supervisory, accounting and disclosure framework in place for effective realization of policy objective of deposit insurance. The respective policy makers are encouraged to evaluate, inter-alia, the state of these regimes before deciding upon the design and implementation of the system. Standard setting bodies such as AAOIFI, IFSB, IASB, BIS, IMF, FSF and BCBS have already provided quite extensive guidelines and standards on these subjects. Their contributions could be of great help to the policy makers for evaluating the state of their respective regimes and identifying the major gaps from the desirables. Further, these contributions could serve as a valuable guiding stones in the process of developing a desirable legal framework, market discipline, and regulatory framework.

Once the policy makers have carried out detailed self assessment of their macro environment, they will move onto to key policy decisions relating to the design and structure features of the deposit insurance

system. The decisions at this stage involve policy choices on the following key design and structure elements:

Establishment of Sharia-compliant DIS: The constitution of DIS in terms of mandate of deposit insurer agency, its powers, structure and governance should facilitate the effective achievement of the policy objectives. The FSF's guidance could be useful in optimizing the decisions on the key aspects. The policymakers should adopt all the significant guiding principles which promote the effectiveness and ensure Sharia compliance. For the tactical decision relating to establishment of corporate governance and internal control regime for the agency, policy makers may draw on the respective work of other standard setting bodies such as IFSB, AAOIFI, FSF and BCBS.

Funding of Sharia-compliant DIS: The sources and scheme of funding for a Sharia-compliant DIS need be consistent with the Sharia principles as well as the principles of effectiveness. The main objective of the DIS is to contribute to the stability of the financial system by providing the explicit protection to member institutions. For this purpose a sound funding structure is imperative for maintaining the public confidence in the system and its smooth operation.

This component puts forth a number of key issues for the consideration of policymakers. Firstly, decision on the sources of fund – govt. appropriation, borrowings, premium from members or combination of these – and their admissibility under Sharia principles. Generally, the main source will be contributions from member institutions themselves. However, there could be provisions for recourse to government and market if need arises. Secondly, the mechanism of funding and its consistency with the Sharia principles as well as the principles of effectiveness. Policymakers have with them two options in this regard: in Ex-ante approach deposit insurance funds are built over the time through collection of annual premiums. Under this approach the funding requirement can be smoothed out over an extended period of time and this approach sounds more equitable as compared to Ex-post approach. Under Ex-post approach the member institutions start to pay premiums or levies when a member institution fails. Thirdly, the premium assessment scheme that is appropriate for the Islamic deposits insurance system and hands out right kind of incentive signal to the member institutions. The policy makers have two options: either to apply a flat rate premium on the member institutions or introduce a differential rate premium based on risk profile of individual banks. This

latter approach, though quite difficult to implement, is preferable since it promotes incentive for strong risk management in banks. Fourthly, the efficient and Sharia compliant management of insurance pool funds. The fund are to be maintained and managed prudently so as to preserve the capital, provide sufficient liquidity to cover operating expenses, and build reserves for meeting the depositors' claims should a member bank fails. The fund is to be invested in line with Sharia consistent principles of finance. This could be a great challenge in economies where the market for Sharia-compliant investment products has not yet fully developed. The standard setting bodies and other forums focusing on the promotion of Islamic finance could be of great help to the policymakers in developing appropriate Sharia-compliant products and their markets.

Membership & Coverage: This element will involve the decision as to which institutions are to be included in the system, and the decision on the products and deposits and extent of their coverage. These decisions are to be optimized on the twin policy objective of Sharia-compliance and effectiveness of the system in terms of its policy objectives. Islamic banks offer a wide variety of deposit options. The option ranges from Savings and Demand accounts that are normally based on Wadiah (safe custody or safe keeping with guarantee) or Qard (loan) agreements to general- and specific-investment accounts based on Modaraba (profit and loss sharing). The question lying with the architects of Islamic deposit insurance will be 'which deposits to cover' and 'extent of coverage'. While deciding upon which deposit or financial instrument to cover, the relative importance of different types of deposits as well as the nature and purpose of the deposits is considered. One of the major challenging issues would be the question regarding the coverage of investment accounts. There could be divergent views on the Sharia admissibility for the inclusion of these deposits into the deposit insurance. The policymakers in collaboration with standard setting bodies will have to find out innovative solutions for these deposits. Since these deposits generally form the substantial part of Islamic deposit portfolio, their exclusion from the DIS might elude basic policy objective of deposit insurance i.e. the stability and soundness of Islamic banking system. Closely associated with the decision on the products and deposits to be covered is the decision on the coverage limit. A too low coverage will not significantly reduce the risk of bank run as the public confidence will not be significantly enhanced under such circumstances. On the other hand a too high coverage could result in excessive risk taking on the part of member institutions and lax market discipline from the large

protected depositors who otherwise have the capacity to exercise discipline.

Expenditure: The expenditures to be made by a deposit insurance agency are generally both revenue and capital in nature. The issue remains with the standard setting bodies and Islamic research institutions to evaluate the admissibility of these expenditures in the light of Sharia principles.

Public Awareness: A strong and objective awareness among the public could significantly enhance the efficacy of a DIS. Features of the system need regular publicity for the maintenance and strengthening of its creditability. The spread of general awareness among the public in Islamic societies could have positive impact even on the outreach of Islamic banking itself. This will lure in the risk-averse saver who is reluctant to invest with Islamic banks due to perceived high risk and lack of confidence due to any governance issues. General Council of Islamic Banks and Financial Institutions in collaboration with local policymakers could help in creating a strong public awareness among the general public.

Conclusion:

The well-designed Sharia-compliant DIS is crucial for the stability and growth of the Islamic banking system. The Sharia-compliant deposit insurance is in its formative phase in most of the economies where Islamic banking is taking its roots. The system for its successful development and operation demands holistic developments in the realms of financial architecture, market infrastructure, legal framework, disclosure and market discipline, and supervisory framework. This objective can only be achieved through concerted efforts from all the stakeholders. The standard setting bodies, Islamic financial institutions, Sharia advisory boards and scholars, research institutions, and the regulators will have to collaborate for realizing the Sharia-compliant DIS that could provide underpinning to the edifice of a sound Islamic financial system.
